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In the Supreme Court of the United States

ERNST & YOUNG AND ERNST & YOUNG LLP,

Petitioners,

v.

BANKRUPTCY SERVICES, INC.,

Respondent.

On Petition for a Writ of Certiorari to The United States Court of Appeals for the Second Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

This case presents two issues relating to the scope of the Seventh Amendment right to a jury trial in bankruptcy proceedings:

1. Whether, when overlapping jury-triable and bench-triable claims are asserted in a bankruptcy proceeding, the jury-triable claims must be tried first, as the Seventh Amendment requires in all other contexts, notwithstanding the Court's contrary but narrow ruling over 40 years ago under a very different bankruptcy regime.

2. Whether this Court's decisions in *Langenkamp* v. *Culp*, 498 U.S. 42, 44-45 (1990) (per curiam), *Granfinanciera, S.A.* v. *Nordberg*, 492 U.S. 33, 57-59 (1989), and *Katchen* v. *Landy*, 382 U.S. 323 (1966), all of which involved the special nature of bankruptcy-related preference and fraudulent-conveyance claims, are properly extended beyond that context so that a creditor filing a proof of claim in a bankruptcy proceeding loses its Seventh Amendment right to a jury trial on *all* elements of the estate's non-bankruptcy common-law counterclaims, which seek not simply disallowance of the claim but substantial damages.

RULE 14.1(b) STATEMENT

All parties are listed in the caption.

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PETITION FOR A WRIT OF CERTIORARI

Ernst & Young and Ernst & Young LLP ("E&Y") respectfully petition for a writ of certiorari to review the judgment of the United States Court of Appeals for the Second Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, 1a-69a) is reported at 529 F.3d 432. The opinions of the district court on appeal from the judgment of the bankruptcy court (App., *infra*, 70a-81a and 82a-130a) are reported at 318 B.R. 761 and 311 B.R. 350. The district court's decisions denying E&Y's motion to withdraw the reference to the bankruptcy court (App., *infra*, 131a-140a and 141a-151a) are unreported, as is the bankruptcy court's order striking E&Y's jury trial demand (App., *infra*, 152a-162a). The bankruptcy court's decision on liability is reported at 247 B.R. 341.

JURISDICTION

The Second Circuit's opinion was filed on June 16, 2008. E&Y's timely petition for rehearing was denied on October 15, 2008. On January 5, 2009, Justice Ginsburg extended the time to petition for a writ of certiorari to February 12, 2009. This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1).

CONSTITUTIONAL PROVISION INVOLVED

The Seventh Amendment of the United States Constitution provides, in relevant part:

> In Suits at common law, where the value in controversy shall exceed twenty dollars, the right of trial by jury shall be preserved * * *.

INTRODUCTION

This case presents important questions regarding the scope of Seventh Amendment jury trial rights in bankruptcy proceedings.

First, the court of appeals held that the rule announced in *Beacon Theatres, Inc.* v. *Westover*, 359 U.S. 500 (1959), which ordinarily requires legal claims to be tried before factually-related equitable claims, is inapplicable in bankruptcy proceedings. After it filed its claim, E&Y was met with two sets of overlapping counterclaims: one brought on behalf of the debtor; the other on behalf of a third-party creditor. It is now undisputed that it was error to have tried the third-party creditor's claims without a jury, and the judgment on those claims has been vacated. The court of appeals refused, however, to vacate the judgment on the debtor's claims, even though violations of the *Beacon Theatres* rule require vacatur of the *entire* judgment below, including issues that were otherwise properly tried without a jury. *Lytle* v. *Household Mfg., Inc.*, 494 U.S. 545, 555-56 & n.4 (1990).

This ruling was made with reluctance, under the perceived compulsion of *Katchen* v. *Landy*, 382 U.S. 323 (1966), which held the *Beacon Theatres* principle inapplicable in bankruptcy. But *Katchen* was a product of a now-superseded jurisdictional regime in which "courts of bankruptcy" were specialized equity courts that had no authority to try legal and equitable issues in a single proceeding. Subsequently, Congress fundamentally altered bankruptcy jurisdiction. As a consequence, application of *Katchen's* narrow exception no longer makes formal or functional sense. Under these circumstances, this Court's in-

tervention is urgently needed, and this case provides an ideal opportunity for the Court to recalibrate for the current bankruptcy regime the appropriate balance between the orderly functioning of the bankruptcy process and core Seventh Amendment interests.

Second, the court of appeals ruled that a creditor who files a proof of claim in the bankruptcy court loses its Seventh Amendment right to a jury trial on the debtor's state-law counterclaims, where those counterclaims implicate issues that are "either defenses to [the creditor's] fees claim or integrally related to those defenses." App., *infra*, 63a. Applying that rule, the court affirmed the bankruptcy court's decision to adjudicate the state-law counterclaims in a bench trial, even though they were otherwise jury-triable common-law claims and included issues, such as damages, that had no bearing on the allowance of E&Y's claim.

That holding is an unwarranted extension of three of this Court's precedents: *Langenkamp* v. *Culp*, 498 U.S. 42 (1990) (per curiam); *Granfinanciera, S.A.* v. *Nordberg*, 492 U.S. 33 (1989); and *Katchen* v. *Landy*, *supra*. Although those cases did find a loss of jury trial rights by a creditor that submitted a claim to the bankruptcy court, (1) they all involved the estate's avoiding-powers, and (2) none sanctioned bench trial of issues that were not necessary to determining whether to allow the creditor's claim. Whether the forfeiture of jury-trial rights is justified beyond that narrow context is an important question meriting this Court's attention.

STATEMENT

1. CBI was a wholesale distributor of pharmaceutical products. In the early 1990s, CBI began borrowing capital to finance a strategy of growth by acquisition. One of CBI's lenders was Trust Company of the West ("TCW"), an investment company. As part of its lending agreement, TCW became a 48% shareholder of CBI.

E&Y became CBI's auditor in 1990. E&Y audited CBI's financial statements for 1992 and 1993, issuing unqualified opinions that CBI's financial statements were fairly presented.

In fact, however, CBI's financial statements were fraudulent. Numerous members of CBI's top management had engaged in an elaborate scheme to overstate CBI's earnings through accounting chicanery involving misrepresentations about the company's inventory and accounts payable. E&Y conducted its audits in reliance on CBI's managers' written representations that there were no management irregularities, that all financial records and relevant data had been tendered to E&Y, and that the financial information provided to the auditors accurately represented the company's situation. All of this was false, but CBI's management was sufficiently adept at concealing its fraud that E&Y failed to discover the company's deception until it was disclosed by a CBI insider in February 1994.

E&Y thereupon took immediate steps to investigate and address the issue, withdrawing its opinion on the 1993 financial statements and commencing a reaudit. That work was never completed, being halted by CBI in July 1994. In August 1994, CBI filed for bankruptcy.

2. E&Y filed a claim in the bankruptcy case seeking $210,850 covering work on the 1994 reaudit and certain tax and consulting services. The creditors' committee objected to the amount of E&Y's claim but did not allege malpractice in the conduct of the reaudit (or in connection with any other work that E&Y had performed for CBI). App., *infra*, 86a-87a.

When the bankruptcy court later confirmed CBI's reorganization plan, it appointed respondent Bankruptcy Services, Inc. ("BSI") as the disbursing agent. As part of that plan, BSI acquired all of CBI's claims, and, pursuant to a settlement with TCW, "all rights to pursue and prosecute causes of action of any kind held by TCW against any third party, in its capacity as [CBI's] Creditor or equity security holder." App., *infra*, 87a-88a.

BSI's amended complaint sought tens of millions of dollars in damages and alleged seven claims. The first four related to E&Y's audits of CBI's financial statements for fiscal years 1992 and 1993: (1) breach of contract, (2) negligence, (3) negligent misrepresentation, and (4) fraud and/or recklessness. The remaining three alleged: (5) fraud and/or recklessness in inducing CBI to retain E&Y for the reaudit, (6) breach of fiduciary duty, and (7) expungement of E&Y's claim. BSI brought all these claims as successor to CBI, and also brought claims (2)-(5) as assignee of TCW.[1] The amended complaint included a jury demand.

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[1] We refer to the claims BSI brought as successor to CBI as the "CBI claims," and the claims brought as assignee of TCW as the "TCW claims."

E&Y then moved in the district court to withdraw the reference to the bankruptcy court for purposes of adjudicating the claims against it. The district court denied the motion, ruling that the dispute was a "core proceeding" within the meaning of 28 U.S.C. § 157(b) that could properly be tried in the bankruptcy court. App., *infra*, 141a-151a. BSI then withdrew its jury demand. The next day, E&Y answered BSI's amended complaint and asserted its own jury trial demand. E&Y also renewed its request for withdrawal of the reference on the ground that the bankruptcy court lacked authority to conduct a jury trial without E&Y's consent.

E&Y's efforts to assert its Seventh Amendment rights proved unsuccessful. The district court rejected E&Y's argument that the bankruptcy court lacked the authority to conduct a jury trial, and remanded to the bankruptcy court without deciding whether a jury trial was in fact required. App., *infra*, 131a-140a. The bankruptcy court then granted BSI's motion to strike E&Y's jury demand. App., *infra*, 152a-162a.

The ensuing bench trial was bifurcated into liability and damages phases. The liability phase was a complicated affair; the trial lasted 17 days, featured 19 witnesses and numerous exhibits, and generated 3,500 pages of transcript. 247 B.R. at 347. The parties disputed critical facts, and the bankruptcy judge made credibility determinations with respect to multiple witnesses, ultimately concluding that E&Y committed malpractice by failing to follow generally accepted auditing standards. *Id.* at 361-64.

After conducting a separate trial on damages, also without a jury, the bankruptcy court awarded approximately $70 million ($45 million on the CBI

claims and $25 million on the TCW claims), and it expunged E&Y's claim against the estate. App., *infra*, 15a-16a.

E&Y appealed to the district court. On the Seventh Amendment issue, the district court affirmed in part and reversed in part. As to the CBI claims, it held that E&Y had no right to a jury trial because CBI's claims are "integrally related to the claims allowance process because BSI's success on those claims would result in the disallowance of Ernst & Young's Proof of Claim." App., *infra*, 105a.

Applying similar principles, the district court found that E&Y *did* have a right to a jury trial on TCW's claims. The court explained that "[e]ven though success on TCW's claims may augment the size of the bankruptcy estate, it will not affect BSI's ability to defend against Ernst & Young's Proof of Claim." App., *infra*, 107a.

E&Y also appealed the bankruptcy court's decision that BSI had standing to raise CBI's and TCW's claims. Ultimately, the district court ruled in E&Y's favor, finding that the TCW claims could not be asserted by BSI and that the CBI claims were barred by *in pari delicto* principles due to CBI's officers' extensive participation in the falsification of the financial statements. It accordingly vacated the entire bankruptcy judgment. App., *infra*, 70a-81a.

3. BSI appealed, and E&Y took a conditional cross-appeal arguing that the bankruptcy court lacked the statutory authority to try the proceedings and that E&Y enjoyed a Seventh Amendment right to a jury trial on the CBI claims.

The Second Circuit reversed the district court on the merits, ruling that BSI had standing to assert

both the CBI and TCW claims. App., *infra*, 23a-48a. In so holding, the court of appeals faulted the district court for failing to accord sufficient deference to the bankruptcy judge's factual findings. App., *infra*, 19a, 26a-35a. The court did not suggest, however, that those findings were the only reasonable view of the evidence. App., *infra*, 28a.

The Second Circuit rejected E&Y's cross-appeal. After holding that both the CBI and TCW claims were "core proceedings" over which the bankruptcy court had jurisdiction (see 28 U.S.C. § 157(b)), the court addressed E&Y's two Seventh Amendment arguments.

First, the court considered whether, by filing a claim in CBI's bankruptcy case, E&Y lost its right to a jury trial on the CBI claims. It was undisputed that E&Y would have been entitled to a jury trial on those claims had it not filed its own claim. App., *infra*, 61a. But the Second Circuit ruled that by filing a claim, a creditor subjects itself to the equitable process in which the bankruptcy court determines whether to allow or disallow the creditor's claim. The creditor loses its jury trial right as to any counterclaim "whose resolution affects the allowance or disallowance of the creditor's proof of claim or is otherwise so integral to restructuring the debtor-creditor relationship." App., *infra*, 62a-63a. This is true, according to the court, regardless of the fact that the counterclaim seeks damages far in excess of the amount at stake in the creditor's claim.

Applying this rule, the court held that E&Y "waived" its right to a jury trial on the entirety of the CBI claims by filing a proof of claim. App., *infra*, 63a. CBI's claims were filed in response to E&Y's claim, and all of CBI's claims were also "either de-

fenses to [E&Y's] fees claim or integrally related to those defenses" such that the resolution of CBI's claims "clearly affects the structuring of the debtor-creditor relationship between CBI and [E&Y]." App., *infra*, 63a.

E&Y had also argued that, because it concededly retained its jury trial right as to the TCW claims, and because those claims presented overlapping factual issues with the CBI claims, this Court's decision in *Beacon Theaters*, and due regard for E&Y's constitutional jury trial right, required the bankruptcy court to have tried the TCW claims before a jury first. E&Y invoked this Court's decision in *Lytle* v. *Household Manufacturing, Inc.*, 494 U.S. 545 (1990), for the proposition that the failure to do so required a retrial on both sets of claims; *Lytle* held as much in the context of an employment discrimination action involving overlapping jury-triable and bench-triable issues.

The Second Circuit acknowledged the general principle, observing that "[a] federal court * * * cannot ordinarily preempt a defendant's Seventh Amendment rights by deciding factual issues on equitable claims that are common to legal claims while reserving those legal claims for a later jury trial." App., *infra*, 66a n.22. It nevertheless held that principle inapplicable here, relying on this Court's decision in *Katchen* v. *Landy*, which it deemed to create a blanket bankruptcy exception to the *Beacon-Lytle* rule, such that bankruptcy courts can conduct the bench trial first even if the resulting judgment would have preclusive effect on factual issues common to the jury-triable claim.

In response to the argument that *Katchen*'s holding had been superseded by substantial changes to

the system for administering bankruptcy cases, the Second Circuit observed that E&Y's

> reasoning may very well be sound, but to no avail. This Court does not have the discretion to ignore Supreme Court precedent simply because the reasoning on which it is premised may seem no longer viable. * * * [A]t least until the Supreme Court holds otherwise, *Katchen* is still good law and Appellees are not entitled to relief under *Lytle*.

App., *infra*, 67a-68a. Thus, the court refused to vacate the bankruptcy court's judgment on the CBI claims, despite that court's acknowledged error in trying the TCW claims without a jury. The court added that "to the degree that the court's judgment on those claims is dispositive of factual issues underlying the TCW claims, [E&Y] may also be collaterally estopped from relitigating those issues at its jury trial on the TCW claims." App., *infra*, 67a.

REASONS FOR GRANTING THE PETITION

This Court should "grant[] certiorari because '[m]aintenance of the jury as a fact-finding body is of such importance and occupies so firm a place in our history and jurisprudence that any seeming curtailment of the right to a jury trial should be scrutinized with the utmost care.'" *Beacon Theatres*, 359 U.S. at 501 (citation omitted) (quoting *Dimick* v. *Schiedt*, 293 U.S. 474, 486 (1935)).

This Court has never held that bankruptcy creditors are without Seventh Amendment rights. Yet the Second Circuit, purporting to rely on this Court's decisions, held that creditors substantially sacrifice their right to a jury trial by filing a claim in a bankruptcy proceeding—a sacrifice going well beyond dis-

allowance of the debt they claim to be owed. This is the product of the court of appeals' two holdings: that creditors waive their right to a jury trial on any issue that somehow relates to their filed claims, and that courts are under no obligation to structure bankruptcy proceedings in a way that protects those Seventh Amendment rights that manage to survive the act of filing a proof of claim.

As to this latter issue, review is needed because only this Court can hold that one of its key decisions in the bankruptcy field has become anachronistic and requires reexamination. The Second Circuit recognized as much, indicating that it may well have decided the *Beacon Theatres* question differently had it possessed the discretion to depart from what it understood to be the binding holding of *Katchen*. Ordinarily, when judicially-created doctrine rests on dynamic factual premises, it is the lower courts' task to ensure that the doctrine keeps pace with real-world developments. Because the *Katchen* Court announced a clear rule, however, the lower courts are powerless. As a result, until this Court reconsiders its prior decision, bankruptcy courts in the 21st century will continue to apply a Seventh Amendment rule predicated on a repealed bankruptcy statute enacted in 1898.

As for the Seventh Amendment consequences of filing a proof of claim, the court of appeals based its holding on this Court's decisions in *Katchen*, *Granfinanciera*, and *Langenkamp*. Although the Second Circuit misunderstood this trilogy, it is not alone in its confusion. Since *Langenkamp* was decided in 1991, lower courts have struggled to understand how filing a proof of claim affects a creditor's right to a

jury trial, and they have split on various applications of this broader question.

The time has come for the Court to give the guidance that the lower courts need. The number of bankruptcy filings is exploding. All filings rose by over 30% from fiscal year 2007 to fiscal year 2008, and business and Chapter 11 filings both rose by 49%.[2] Because creditors can be expected to file proofs of claim in virtually all of these cases, and because a concomitant proliferation of counterclaims can be expected, the threat to Seventh Amendment rights is substantial. By acting now, this Court can ensure that the lower courts resolve the growing number of bankruptcy cases with due regard for jury-trial rights.

The present case is an ideal vehicle for revisiting this issue. Although the inequity in this case is extraordinary—a $210,850 claim was held to have forfeited jury trial rights on counterclaims seeking tens of millions of dollars—the nature of the dispute is not. A decision in this case would apply to a significant percentage of the cases in this nation's bankruptcy courts. Under these circumstances, review is in order.

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[2] See News Release, Admin. Office of the U.S. Courts, *Bankruptcy Filings Over One Million for Fiscal Year 2008* (Dec. 15, 2008), available at http://www.uscourts.gov/Press_Releases/2008/BankruptcyFilingsDec2008.cfm (last visited Feb. 10, 2009).

I. THE CONTINUING VALIDITY OF THE *KATCHEN* EXCEPTION TO *BEACON THEATRES* IS A CRITICAL ISSUE THAT ONLY THIS COURT CAN RESOLVE.

Relying on *Katchen*, the Second Circuit ruled that the holding of *Beacon Theatres*—the ordinary rule that legal claims must be resolved by a jury before factually-related equitable claims are tried to the court—does not apply in bankruptcy. The narrow exception *Katchen* carved out from *Beacon Theatres* was, however, a product of the archaic bankruptcy regime in place at the time, under which law and equity were divided and overlapping factual and legal claims could not be addressed in a single forum. That regime is now gone, and the fundamental changes in bankruptcy procedure that have been made since *Katchen* was decided render its exception unnecessary and improper.

The Second Circuit agreed that this "reasoning might very well be sound" but concluded that it "does not have the discretion to ignore Supreme Court precedent simply because the reasoning on which it is premised may seem no longer viable." App., *infra*, 67a-68a. Thus, the court concluded that it was bound by *Katchen* "at least until the Supreme Court holds otherwise." *Ibid.* Under those circumstances, and because abiding by *Katchen* is not only senseless, but also invites—as it did in this case—a significant constriction of meaningful jury-trial rights, this Court's review is needed.

1. In *Beacon Theatres*, and in *Dairy Queen, Inc.* v. *Wood*, 369 U.S. 469 (1962), this Court announced a bedrock procedural rule meant to give substance to the Seventh Amendment's core guarantee:

> [W]here both legal and equitable issues are presented in a single case, "only under the most imperative circumstances, circumstances which in view of the flexible procedures of the Federal Rules we cannot now anticipate, can the right to a jury trial of legal issues be lost through prior determination of equitable claims."

Dairy Queen, 369 U.S. 469, 472-73 (1962) (quoting *Beacon Theatres*, 359 U.S. at 510-11).

More recently, in *Lytle* v. *Household Manufacturing, Inc.*, *supra*, this Court applied *Beacon Theatres* to a situation involving overlapping equitable and legal claims, where the trial court erroneously dismissed the legal claim and conducted a bench trial on the equitable claim, finding for the defendant. The court of appeals held that the legal claim had been erroneously dismissed but nevertheless upheld the judgment based on the preclusive effect of the findings in the bench trial. See *Lytle*, 494 U.S. at 549-50.

This Court reversed. Reaffirming its "longstanding commitment to preserving a litigant's right to a jury trial" (*Lytle*, 494 U.S. at 554), it found it necessary in the circumstances to vacate the equitable judgment in order to afford "complete and consistent relief." *Id.* at 556 n.4. In particular, the Court was concerned about giving collateral-estoppel effect to the determinations made in the equitable proceeding, which would effectively vitiate the jury trial right. *Id.* at 555.

This case squarely implicates these decisions. As in *Dairy Queen* (see *Lytle*, 494 U.S. at 553), the trial court here erroneously concluded that the entire case

against E&Y could be tried by the court. And, as in *Lytle*, that error threatens to sabotage any meaningful right to a jury trial on TCW's yet-to-be-tried legal claims. App., *infra*, 67a. Thus, application of the *Lytle* rule would result in vacating the CBI judgment and directing that the jury-triable TCW claims be tried first. "To hold otherwise," as this Court recognized in *Lytle*, "would seriously undermine" the "jury trial right under the Seventh Amendment." 494 U.S. at 555.

2. But the Second Circuit refused to apply *Lytle*, holding that "under the Supreme Court's decision in *Katchen*," the rule of *Beacon Theaters* and *Lytle* "does not apply in the context of bankruptcy proceedings." App., *infra*, 66a.

The *Beacon Theatres* rule was indeed at issue in *Katchen*. Invoking that rule, the *Katchen* creditor argued that the trustee's preference *objection*, conceived as a request for equitable relief, could be resolved only after a jury trial on the trustee's preference *claim*, which requested legal relief.[3] The Court rejected this argument on account of the intractable logistical problems it would have created under the bankruptcy scheme then in place. The creditor's position would have required the "bankruptcy court [to] stay its own proceedings and direct the bankruptcy trustee to commence a plenary suit" in another forum. *Katchen*, 382 U.S. at 338. This might have caused years of delay in settling the debtor's estate. The Court held that applying *Beacon Theatres* under those circumstances would create unacceptable "de-

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[3] The distinction between preference objections and preference claims is explained in Part II.A.I, *infra*.

lay and expense" and "dismember a scheme which Congress has prescribed." *Id.* at 339.

Katchen's reasoning thus was premised on the archaic jurisdictional scheme that governed bankruptcy proceedings at that time. Under the Bankruptcy Act of 1898, "courts of bankruptcy" exercising "summary jurisdiction" (the equitable jurisdiction under which they allowed and disallowed claims) could not simultaneously exercise "plenary jurisdiction" (the jurisdiction at law under which a state or federal district court could hold a jury trial). See S. Elizabeth Gibson, *Jury Trials in Bankruptcy: Obeying the Commands of Article III and the Seventh Amendment*, 72 Minn. L. Rev. 967, 971-72 (1988). As a result, had this Court held that creditors were entitled to a jury trial on preference claims, it would have "require[d] that in every case where a [preference] objection is interposed and a jury trial is demanded the proceedings on allowance of claims must be suspended and a plenary suit initiated." *Katchen*, 382 U.S. at 339. Such a scheme, with the potential for multiple trials in different courts, was unworkable and inequitable. *Ibid.*

3. The statutory scheme at issue in *Katchen* put the bankruptcy courts in a position akin to that of the federal district courts prior to the advent of the Federal Rules of Civil Procedure. For the first century and a half of their existence, district courts could not try legal and equitable issues in the same proceeding, even though the district courts were clothed with both legal and equitable jurisdiction. "[W]hen sitting in equity, the [district] judge was technically a different court than when sitting at law." G. Ray Warner, *Katchen Up in Bankruptcy:*

The New Jury Trial Right, 63 Am. Bankr. L.J. 1, 7 (1989) [hereinafter Warner, *Katchen*].

During that time, a district court presiding over a case in equity would occasionally confront a legal action involving the same parties and the same issues. In cases where the legal remedy was inadequate or the equity plaintiff might suffer irreparable harm, the court could enjoin the legal action pending the outcome of the equity trial in order to ensure that the equity plaintiff enjoyed "a fair and orderly adjudication of the controversy." *Beacon Theatres*, 359 U.S. at 506-07. The consequence of such a system, however, was that the parties suffered diminished jury trial rights, for the common issues decided in the antecedent equitable trial were binding in the later action at law. Warner, *Katchen*, *supra*, at 12.

In 1938, the Federal Rules merged district courts' law and equity jurisdictions. See *Warner*, *Katchen*, *supra*, at 9. The merger empowered district courts to hold a jury trial on all legal issues and then award whatever equitable relief may be appropriate for overlapping or separate equitable issues. See 9 Charles Alan Wright & Arthur R. Miller, FEDERAL PRACTICE AND PROCEDURE § 2305 (3d ed. 2008). The merger therefore eliminated the need for multiple trials, and with it the threat to the equity plaintiff's fair and orderly adjudication of the controversy.

It was this landmark procedural reform that produced the holding in *Beacon Theatres*. As the Court explained, "equity has always acted only when legal remedies were inadequate," so the pre-merger rule had to be "re-evaluated in the light of the liberal joinder provisions of the Federal Rules which allow legal and equitable causes to be brought and resolved in one civil action." 359 U.S. at 509. After merger,

there was no longer any functional justification for impairing the jury trial right "because the unified court easily could provide a jury trial without affecting the equity plaintiff's rights" to a fair and orderly adjudication. Warner, *Katchen*, *supra*, at 12-14; see also *Dairy Queen*, 369 U.S. at 469-73; John C. McCoid, II, *Procedural Reform and the Right to Jury Trial: A Study of Beacon Theatres, Inc.* v. *Westover*, 116 U. Pa. L. Rev. 1, 6 (1967) (explaining that *Beacon Theatres* rule was the consequence "of a procedural reform, the merger of law and equity").

But the bankruptcy courts had undergone no comparable procedural reform when *Katchen* was decided in 1966. This Court thus could not apply *Beacon Theatres* to the bankruptcy regime because the premise of that holding—the merger in a single court of legal and equitable jurisdiction—did not yet exist. Accordingly, to insist that equitable determinations await the resolution of overlapping legal claims would have been—just as it was in the pre-merger regime in the district courts—to deny debtors and creditors their right to a fair and orderly adjudication. This significant limitation on bankruptcy jurisdiction provided the central premise for the result reached in *Katchen*. See Warner, *Katchen*, *supra*, at 17-42. Indeed, against this backdrop, *Katchen*'s concern with "delay and expense" was no mere cavil; it was an accurate recognition that Congress' desire for a swift and orderly resolution of the estate would have been defeated by a multitude of jury trials in various courts.

4. The statutory premises underlying *Katchen*'s refusal to apply *Beacon Theatres* have now been eliminated. After this Court's decision in *Northern Pipeline Constr. Co.* v. *Marathon Pipe Line Co.*, 458

U.S. 50 (1982), Congress passed the Bankruptcy Amendments and Federal Judgeship Act of 1984. Pub. L. No. 98-353, 98 Stat. 333. The Act vested bankruptcy jurisdiction not in specialized bankruptcy courts, but instead in the federal district courts, which were given original jurisdiction over all cases under title 11, all proceedings arising under title 11, and all proceedings arising in or related to cases under title 11. *Id.* § 101, 98 Stat. at 333 (codified at 28 U.S.C. § 1334(a), (b)). District courts were empowered to "refer[]" such matters to the bankruptcy courts, which were reconstituted as "unit[s] of the district court[s]." *Id.* § 104(a), 98 Stat. at 336, 340 (codified at 28 U.S.C. §§ 151, 157(a)). But the district court retained the power to reassert control of the case by withdrawing the reference. *Id.* § 104(a), 98 Stat. at 340 (codified at 28 U.S.C. § 157(d)). These provisions remain in force today.

In light of these profound statutory changes, which brought about the merger of law and equity in bankruptcy proceedings, there is no longer any formal or functional reason for maintaining the *Katchen* exception to the *Beacon Theatres* rule.

Formally, the 1984 amendments made bankruptcy courts units of the district courts, which can try legal and equitable issues in a single case. As a result, it is now "possible for the court to grant legal relief and provide jury trials, while at the same time according complete and prompt relief to the equity plaintiff." Warner, *Katchen*, *supra*, at 48.

In short, the bankruptcy courts are no longer the "specialized court[s] of equity" that they were when *Katchen* was decided. And that makes all the difference; cases decided after *Katchen* made clear that the so-called "*Katchen* corollary" is applicable only on a

pre-merger conception of the distinction between law and equity. See, *e.g.*, *Atlas Roofing Co.* v. *Occupational Safety & Health Review Comm'n*, 430 U.S. 442, 454 n.11 (1977); *Curtis* v. *Loether*, 415 U.S. 189, 195 (1974); Warner, *Katchen*, *supra*, at 35-42; cf. Charles W. Wolfram, *The Constitutional History of the Seventh Amendment*, 57 Minn. L. Rev. 639, 644 (1973) (explaining that the *Beacon Theatres* test requires "that before the court determines that it must deprive a party of the right to jury trial by prior adjudication of any 'equitable' matter, it should determine whether there is any device available, including any procedural innovations of the Federal Rules, that will permit prior trial by jury").

There can also be no functional objection to jury trials in bankruptcy proceedings. That does not mean that jury trials might not sometimes entail some degree of marginal delay and expense over a bench trial of the same issues, but that is worlds apart from what confronted the Court in *Katchen*. And those ordinary costs cannot provide the basis for rejecting the application of the *Beacon Theatres* rule and the Seventh Amendment interests it protects. *Granfinanciera* made that clear, holding that even if jury trials "would impede swift resolution of bankruptcy proceedings and increase the expense of Chapter 11 reorganizations," such "'considerations are insufficient to overcome the clear command of the Seventh Amendment.'" 492 U.S. at 63 (quoting *Curtis*, 415 U.S. at 198); see also *Lytle*, 494 U.S. at 553-54 ("concern about judicial economy" "remains an insufficient basis for departing from our longstanding commitment to preserving a litigant's right to a jury trial"). Indeed, an "exception of that breadth would override the seventh amendment in all cases." Warner, *Katchen*, *supra*, at 48.

5. Applying *Beacon Theatres* and *Lytle* would require the judgment on the CBI claims to be vacated in order to ensure that E&Y's undisputed right to a jury trial of the factually-overlapping TCW claims is preserved. See *Lytle*, 494 U.S. at 555 & 556 n.4.[4] The court of appeals did not grant such relief because of the vestiges of *Katchen* and the rule that the lower courts must leave to this Court "'the prerogative of overruling its own decisions.'" App., *infra*, 68a (quoting *Rodriguez de Quijas* v. *Shearson/Am. Express Inc.*, 490 U.S. 477, 484 (1989)).[5] In order to protect the right to trial by jury, the Court should exercise that prerogative here.

II. THIS COURT'S PRECEDENTS DO NOT COMPEL DENIAL OF A JURY TRIAL ON THE CBI CLAIMS.

Beacon Theatres aside, the court of appeals erred in ruling that the CBI claims could be tried without a jury, on account of a misreading of this Court's precedents. This misreading too presents an important

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[4] The same would be true even viewing the CBI claims on a standalone basis. They involve legal causes of action triable to a jury (the counterclaims) and overlapping issues constituting defenses to E&Y's claim (triable to the court). Under *Beacon Theaters*, preservation of jury trial rights would require the jury trial to go first.

[5] The Second Circuit cited *Parklane Hosiery Co.* v. *Shore*, 439 U.S. 322, 334-35 (1979), in stating that "*Katchen's* relevant holding has been repeatedly reaffirmed after the Bankruptcy Code of 1978." App., *infra*, 68a. But *Parklane* predated the 1984 amendments, and it cited *Katchen* merely for the uncontroversial proposition "that an equitable determination can have collateral-estoppel effect in a subsequent legal action and that this estoppel does not violate the Seventh Amendment," *Parklane Hosiery*, 439 U.S. at 335, a proposition E&Y does not contest.

question regarding the intersection of bankruptcy and jury-trial rights.

This Court has addressed the scope of Seventh Amendment rights in the bankruptcy process three times. Taken together, *Katchen*,[6] *Granfinanciera*, and *Langenkamp* establish a narrow rule: creditors who file a proof of claim have no right to a jury trial on trustees' avoiding-power claims of fraudulent transfer or preference payments. That rule derives from the unique role of recoverable transfers in bankruptcy law and the operation of the equitable "unclean hands" doctrine.

This case, however, does not involve those avoiding powers but instead a routine common-law malpractice claim brought for the benefit of CBI's estate against its former auditor. There is no dispute that E&Y would have been entitled to a jury trial had it not filed its own claim. See App., *infra*, 61a. Yet the Second Circuit held that right waived because some of the factual issues to be resolved in adjudicating the CBI claims also bear on whether E&Y's claim should be allowed. Because that holding is a significant extension of this Court's precedents and a significant contraction of Seventh Amendment rights, review is warranted.

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[6] In the preceding section, Part I, we address the portion of *Katchen* that considered the *Beacon Theatres* rule. See 382 U.S. at 338-40. Here, we focus on *Katchen's* holding that the creditor lost its jury trial right on the debtor's preference claim by filing a proof of claim in the bankruptcy court. See *id.* at 336-38.

A. Outside The Limited Context Of Avoiding-Power Claims, This Court Has Never Suggested That A Bankruptcy Creditor Loses Its Jury Trial Rights Merely By Filing A Proof Of Claim.

1. This Court first addressed the Seventh Amendment issue in *Katchen*. There, after the creditor filed a claim in the bankruptcy court, the trustee alleged that the creditor had benefited from certain voidable preferential transfers. Then, as now, creditors who received a preference were vulnerable to two types of attacks. First, the estate's representative could assert a *claim* to recover the property transferred or the value thereof. 11 U.S.C. § 96(b) (1964) (revised and recodified at *id.* § 550). Second, the representative could "object" to consideration of the creditor's claim on the estate. By statute, bankruptcy courts could not "allow" the claims of a creditor who had received a preference or fraudulent transfer—*i.e.*, could not let such creditors participate in the bankruptcy distribution—until they returned such transfers to the estate. *Id.* § 93(g) (revised and recodified at *id.* § 502(d)). The trustee in *Katchen* asserted both types of attacks.

It was in that context that this Court held that bankruptcy courts could award relief on the preference claim under their "summary jurisdiction"[7] with-

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[7] Under the Bankruptcy Act of 1898 (the applicable bankruptcy statute at the time *Katchen* was decided), bankruptcy matters either fell within bankruptcy courts' "summary jurisdiction," or had to be tried in "plenary suits." Summary proceedings were typically tried by bankruptcy referees without a jury. See Gibson, *supra*, 72 Minn. L. Rev. at 971-72. Matters that fell outside bankruptcy courts' summary jurisdiction were tried in ple-

out running afoul of the Seventh Amendment. That was so even though the creditor would have been entitled to a jury trial on the preference claim had he not submitted a proof of claim. *Katchen*, 382 U.S. at 336.

The Court's analysis rested on three premises. First, the claims-allowance process—the process in which a bankruptcy court allows or disallows a creditor's claim—is equitable. Because the preference *objection* was part of that equitable claims-allowance process, the bankruptcy court could properly resolve the objection without the aid of a jury. *Katchen*, 382 U.S. at 330-33, 336-37. Second, the bankruptcy court was statutorily required to determine the trustee's *entire* preference claim in the course of resolving the trustee's preference objection. *Id.* at 332 n.9, 334. Third, issues decided in the claims-allowance process had preclusive effect in subsequent proceedings between the parties. As a result, once a bankruptcy court resolved the equitable preference *objection*, "nothing remain[ed] for adjudication" on the trustee's *claim*. *Id.* at 334. Under these circumstances,

> it makes no difference, so far as [the creditor's] Seventh Amendment claim is concerned, whether the bankruptcy trustee urges only a[n] * * * objection or also seeks affirmative relief. In practical effect, the denial of a jury trial would be no less were the bankruptcy court merely to determine the existence and amount of the preference [objection], since that determination would be entitled to res judicata effect in any subsequent [jury] action.

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nary suits in state court or, if jurisdiction existed, in federal district court. *Id.* at 972.

Id. at 337-38.

In *Granfinanciera*, the trustee asserted a fraudulent-conveyance claim against a creditor that had not filed a claim in the bankruptcy proceeding. The Court held that the creditor was constitutionally entitled to a jury trial, even though Congress apparently intended to have such claims tried without a jury. 492 U.S. at 36, 60-64. Congress, the Court explained, can deny a litigant a jury trial on a legal claim only if the dispute involves a matter of "public rights." *Id.* at 51-55. Fraudulent conveyance claims were legal: they would have been tried in 18th century courts of law, and a successful plaintiff can recover money damages. *Id.* at 43-49. Turning to the public rights question, the Court held that even if the bankruptcy process could be described as a public right—a proposition that the Court refused to endorse— fraudulent conveyance claims remained matters of private right. *Id.* at 56.

Langenkamp, like *Katchen*, involved a preference claim. The trustee asserted such a claim against two groups of creditors—some who had filed proofs of claim, and some who had not. Although, as we discuss below, the Court's terse opinion was opaque, it confirmed that creditors who file a proof of claim have no right to a jury trial on a trustee's preference action, whereas creditors who do not file any claim retain that right. *Langenkamp*, 498 U.S. at 44.

2. These three cases share one especially salient feature: they all involved "avoiding-power" claims for return of preference or fraudulently conveyed payments. Avoiding powers are "the powers given a trustee in bankruptcy to avoid property interests held by entities other than the debtor both in property that belonged to the debtor prior to bankruptcy

but was transferred away and is property of the estate." Thomas H. Jackson, *Avoiding Powers in Bankruptcy*, 36 Stan. L. Rev. 725, 725 n.1 (1984) (citation omitted). Thus, although *Katchen*, *Granfinanciera*, and *Langenkamp* establish that the filing of a claim can limit a creditor's right to a jury trial on avoiding-power counterclaims, this Court has *never* held that the same consequence extends to *non*-avoiding-power counterclaims, let alone traditional common law counterclaims seeking money damages.

The Second Circuit's decision in this case ignores that significant distinction. The court held that E&Y lost its right to a jury trial not on an avoiding-power claim (as in *Katchen* and *Langenkamp*), but on a set of routine common-law damages claims. In so holding, the court overlooked important differences between avoiding-power claims and other claims asserted on the debtor's behalf. Those differences explain why this Court's decisions limiting creditors' jury-trial rights have reached only as far as the avoiding-power situation.

Put simply, a bankruptcy trustee's avoiding-power objections are equitable in a way that a debtors' other claims are not. The preference and fraudulent conveyance claims featured in this Court's precedents target behavior that presents an especially serious threat to the bankruptcy scheme. One of the primary purposes of bankruptcy is to distribute the debtor's assets fairly among creditors; and as to unsecured, general creditors, "the cardinal bankruptcy principle is equal and ratable distribution." 3 William L. Norton, Jr., BANKRUPTCY LAW AND PRACTICE § 49:1 (3d. ed. 2008).

A fraudulent conveyance is "essentially * * * an act which has the effect of improperly placing assets

beyond the reach of creditors." 5 COLLIER ON BANKRUPTCY ¶ 548.01 (15th rev. ed. 2008). Preferences are "transfers that favor one existing creditor over another," Jackson, *Avoiding Powers in Bankruptcy*, *supra*, 36 Stan. L. Rev. at 757; see also 11 U.S.C. § 547(b). Both fraudulent conveyances and preferences frustrate the distributional purpose of bankruptcy law by reducing the size of the estate to be divided up among the creditors in bankruptcy court. And preferences offend the equality principle as well, by providing one creditor with a larger share of the debtor's property than it is entitled to.

Accordingly, the trustee's ability to target both fraudulent conveyances and preferences through its avoiding powers has a common purpose: "to prevent a debtor from diminishing, to the detriment of some or all creditors, funds that are generally available for distribution to creditors." *In re Chase & Sanborn Corp.*, 813 F.2d 1177, 1181 (11th Cir. 1987). These powers are essential to a well-functioning bankruptcy system. Without them, debtors and complicit creditors could flout Congress' bankruptcy policies and leave the bankruptcy court to dispose of only those assets that the debtor chose to retain in its estate.

For nearly 150 years, therefore, Congress has singled out preference recipients for a unique disability. In the Bankruptcy Act of 1867, Congress expressly prohibited courts from allowing preference creditors' claims against the debtor's estate until they surrendered "all property, money, benefit, or advantage received * * * under such preference." Ch. 176, § 23, 14 Stat. 517, 528. Although the language varied, that provision carried through to the Bankruptcy Act of 1898, ch. 541, § 57(g), 30 Stat. 544, 560,

and remains in the current bankruptcy code, 11 U.S.C. § 502(d).

When, at the time of *Katchen*, an estate's representative invoked the disallowance provision—when it raised an avoiding-power objection to a creditor's claim—it was requesting that the court resolve an *equitable* issue. That is because the provision is a bankruptcy-tailored application of a familiar equity maxim: those who seek equitable relief must enter courts of equity with "clean hands"; they must not have acted in a manner that offends equity. See, *e.g.*, *Precision Instrument Mfg. Co.* v. *Auto. Maint. Mach. Co.*, 324 U.S. 806, 814 (1945); John Norton Pomeroy, 1 POMEROY'S EQUITY JURISPRUDENCE § 397 (3d ed. 1905).

Katchen's holding makes perfect sense in light of the unclean-hands doctrine. The Court made clear that the bankruptcy statute is "concerned with *creditors* rather than *claims* and thus contemplates that allowance of a claim may be conditioned on surrender of preferences received with respect to transactions unrelated to the claims." 382 U.S. at 330 n.5 (construing 11 U.S.C. § 93(g)). *Katchen* thus recognized a standing-like requirement for creditors who submit claims against a bankruptcy estate. Because Congress generally does not condition judicial relief on a plaintiff's willingness and ability to atone for past behavior, there is a strong inference that the disallowance provision was intended to simulate the unclean hands maxim. Cf. *Young* v. *United States*, 535 U.S. 43, 50 (2000) (stating that bankruptcy courts "'apply the principles and rules of equity jurisprudence'") (quoting *Pepper* v. *Litton*, 308 U.S. 295, 304 (1939)).

Viewing avoiding-power objections as invocations of the unclean hands doctrine reveals why the filing of a proof of claim carries so much weight in this Court's Seventh Amendment analysis of avoiding-power claims. Creditors who received preferences or fraudulent conveyances transgressed in a way that particularly offends the equitable process of restructuring debtor-creditor relations. Such creditors should not be able to recover from the estate if they have participated in a distortion of the bankruptcy process by receiving a preference or a fraudulent conveyance. And, in that context, the effort by the estate's representative to protect the integrity of the bankruptcy process by invoking the avoiding powers is an assertion of an equitable principle appropriately tried in equity without a jury.

In contrast, where the creditor files no claim, and thus does not request any equitable relief, the unclean-hands doctrine is never triggered. When such a creditor is sued in a fraudulent conveyance action, it retains its right to a jury trial because the inquiry is a *legal* one concerning the trustee's efforts "to augment the bankruptcy estate," *Granfinanciera*, 492 U.S. at 56, rather than an *equitable* one concerning the creditor's fitness for a judgment in equity.

3. Under a proper Seventh Amendment analysis, therefore, a creditor, like E&Y, that files a claim in the bankruptcy court that does not trigger the disallowance provisions (and thus does not face avoiding-power claims that must be adjudicated as part and parcel of the claims-allowance process) should not lose its right to a jury trial on the debtor's legal claims against it. The Second Circuit mistakenly believed that the Seventh Amendment analysis turned entirely on the creditor's filing of a claim against the

estate. Although a necessary factor, that is not a sufficient one, for there must also be an assertion of a statutory avoiding-power objection in order to render the dispute equitable. That mistake led the court of appeals to venture beyond this Court's precedents and foreclose a jury trial in a case involving traditional state-law damages claims. That result is theoretically unsound and represents a dramatic abridgment of the Seventh Amendment. This Court's review is warranted to restore the jury trial to its proper place within the bankruptcy system.

B. *Langenkamp's* Apparent Application Of The Public Rights Theory Has Created Doctrinal Confusion.

The Second Circuit's restrictive reading of the Seventh Amendment is partially ascribable to doctrinal confusion caused by *Langenkamp*'s oblique reference to the public rights doctrine. Although *Langenkamp* affirmed the outcomes of *Katchen* and *Granfinanciera*, its short per curiam opinion is far from clear. The Court first appeared to adopt *Katchen's* and *Granfinanciera's* reasoning, explaining that a preference objection is "part of the claims-allowance process, which is triable only in equity." *Langenkamp*, 498 U.S. at 44. However, the Court then pulled language from the *Granfinanciera* Court's articulation of the public rights doctrine, holding that "the creditor's claim and the ensuing preference action by the trustee become integral to the restructuring of the debtor-creditor relationship through the bankruptcy court's *equity jurisdiction*." *Ibid.*

It is unclear what to make of that sentence. See G. Ray Warner, *Rotten to the "Core": Essay on Juries, Jurisdiction and Granfinanciera*, 59 UMKC L.

Rev. 991, 1003 n.77, 1026-29 (1991). One could read it to mean that the restructuring of debtor-creditor relations is a public right, and further that there is no right to a jury trial on any issue that Congress assigns to the bankruptcy court's "equity jurisdiction"—whatever that may be. Yet in *Granfinanciera*, decided only 17 months before *Langenkamp*, a majority of the Court expressed doubt that the restructuring of the debtor-creditor relationship is a public right, 492 U.S. at 56 n.11, and Justice Scalia expressly disagreed with the public-rights portion of the majority's opinion because he believed that that doctrine applies only when the United States is a party. *Id.* at 65-71 (concurring opinion). There is fair reason to conclude, then, that the public rights language in the summary reversal in *Langenkamp* was intended to do no more than reaffirm *Katchen*.

The Second Circuit certainly seemed puzzled. The court did not follow *Granfinanciera's* two step analysis, which inquires (1) whether the issue is legal or equitable, and (2) if legal, whether it involves a matter of public right. Instead, the court of appeals blended the analysis, holding that if a matter affects the equitable claims allowance process it *is* a matter of public right, which defeats the jury-trial right on *all* elements of the dispute. As the court explained in the course of finding that E&Y had no right to a jury trial, because "the CBI claims are either defenses to E & Y's fees claim or integrally related to those defenses, the resolution of the CBI claims clearly affects the structuring of the debtor-creditor relationship between CBI and E & Y." App., *infra*, 63a.

Other lower courts share the Second Circuit's confusion and have likewise relied on this Court's decisions as support for the bankruptcy court's au-

thority to conduct a bench trial on an estate's non-avoiding-power claims and on issues, such as damages, that have no bearing on the claims-allowance process.[8] On other applications of the Seventh Amendment problem, the lower courts are split. For example, courts diverge as to whether creditors who seek a setoff against a recovery sought by a trustee lose their jury trial rights,[9] and they disagree about whether a creditor who has not filed a claim and who is sued by the estate can lose its jury trial rights by filing a counterclaim against the estate.[10]

These errors and conflicts would be resolved by a more consistent and clearly-articulated Seventh Amendment theory. This Court should grant review and clarify the proper analysis in cases where a debtor asserts a legal claim in the bankruptcy court against a creditor.

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[8] See, *e.g.*, *In re Enron Creditors Recovery Corp.*, 07 Civ. 10612, 2008 WL 718284, at *4-*7 (S.D.N.Y. Mar. 17, 2008); *In re Worldcom, Inc.*, 378 B.R. 745 (Bankr. S.D.N.Y. 2007); *In re McClelland*, 332 B.R. 90 (Bankr. S.D.N.Y. 2005); *In re Applied Thermal Sys., Inc.*, 294 B.R. 784, 790-91 (Bankr. N.D. Okla. 2003).

[9] Compare *In re Concept Clubs, Inc.*, 154 B.R. 581, 587-89 (D. Utah 1993), with *In re Hedstron Corp.*, No. 05 C 6888, 2006 WL 1120572 (N.D. Ill. Apr. 24, 2006); *In re Commercial Fin. Servs., Inc.*, 251 B.R. 397 (Bankr. N.D. Okla. 2000).

[10] See *Container Recycling Alliance* v. *Lassman*, 359 B.R. 358, 361-62 (D. Mass. 2007) (noting split and citing cases); see also *In re Peachtree Lane Assocs., Ltd.*, 150 F.3d 788, 797-99 (7th Cir. 1998).

C. Even If Issues Bearing On The Claims-Allowance Process May Generally Be Tried To The Court There Is No Basis For Stripping A Creditor Of Its Jury-Trial Rights As To Issues That Lack Such Effect.

Even were the Court to agree with the Second Circuit that the forfeiture of jury trial rights extends beyond avoiding-power issues to any aspect of a counterclaim that bears on allowance of the creditor's claim, the decision below nevertheless outruns its rationale. The court held that the bankruptcy court could try *all* aspects of the CBI claims without a jury, even though the trial encompassed fact issues that had nothing to do with whether the E&Y claim should be allowed: (1) whether the company officers perpetrating the fraud were acting exclusively for their personal interests and adversely to the company's interests, thereby making inapplicable the *in pari delicto* doctrine that would ordinarily bar the CBI claims; and (2) the amount of damages suffered by CBI as a result of any alleged malpractice by E&Y. That overbroad forfeiture needlessly abridges Seventh Amendment rights and rests on a profound misunderstanding of this Court's cases. The question whether E&Y could properly be deprived of its jury-trial right as to issues not germane to resolution of its bankruptcy claim is an important aspect of the general issue of jury trial rights in bankruptcy proceedings that also warrants this Court's consideration.

Assuming a bench trial was permissible at all (despite the objections raised in the preceding sections), it should have been limited to trying the issues that bore directly on allowance or disallowance

of E&Y's claim. That theoretical basis for forfeiture of jury-trial rights cannot support their extinction with respect to issues that do not affect the creditor's claim and objections thereto. And, indeed, *Katchen* did not hold that bankruptcy courts can award relief on entire claims simply because some aspect of those claims *affects* the allowance of the creditor's claim. Compare App., *infra*, 62a-63a (Second Circuit's holding that creditor loses its jury-trial right "with respect to *claims* whose resolution *affects* the allowance or disallowance of the creditor's proof of claim") (emphasis added). Rather, the Court held, far more narrowly, that a bankruptcy court can award an estate legal relief if the trustee's objection to the creditor's claim also fully establishes the trustee's claim for affirmative relief. The Court explicitly noted the limits of its holding: "we obviously intimate no opinion concerning whether the referee has summary jurisdiction to adjudicate a demand by the trustee for affirmative relief, *all of the substantial factual and legal bases for which have not been disposed of in passing on objections to the claim.*" *Katchen*, 382 U.S. at 332 n.9 (emphasis added).

In sum, even assuming that *Katchen* applies beyond the context of avoiding-power claims, there is an important related question, also worthy of this Court's consideration, as to whether it is consistent with the Seventh Amendment to have a bench trial of *all* issues presented by a partially overlapping claim or only on the overlapping issues.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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APPENDIX A

[Opinion of the United States Court of Appeals For the Second Circuit (June 16, 2008)]

United States Court of Appeals, Second Circuit.

In re CBI HOLDING COMPANY, INC., Debtor,

Bankruptcy Services, Inc., Plaintiff–Appellant–Cross–Appellee,

v.

Ernst & Young, Ernst & Young LLP, Defendants–Appellees–Cross– Appellants.

Docket Nos. 04–5972–bk(L), 04–6300–bk(XAP).

June 16, 2008.

Before WINTER, SOTOMAYOR, and WESLEY, Circuit Judges.

WESLEY, Circuit Judge:

In August 1994, CBI Holding Company, Inc. and all but one of its subsidiaries (collectively, "CBI") filed voluntary petitions for relief under Chapter 11 of the Bankruptcy Code. Ernst & Young and Ernst & Young LLP (together, "E & Y"), the pre-bankruptcy accountants for CBI and Defendants-Appellees in this action, filed a Proof of Claim against CBI in those proceedings for allegedly unpaid auditing and consulting services. On August 23, 1995, the United States Bankruptcy Court for the Southern District of

New York (Lifland, J.) confirmed a Plan of Reorganization ("the Plan") and appointed Bankruptcy Services, Inc. ("BSI"), the Plaintiff-Appellant in this action, the disbursing agent of the Plan. On October 16, 1996, BSI filed a complaint in the bankruptcy court, followed by an amended report on October 25, 1996, pressing seven claims against E & Y concerning the professional services E & Y rendered to CBI from 1992 to 1994. BSI brought each of the seven claims as the successor to the claims of CBI under the Plan (collectively, "the CBI claims"). Pursuant to a settlement contained in the Plan, BSI also brought four of these claims as the assignee of the claims that Trust Company of the West ("TCW") acquired as a pre-bankruptcy creditor of CBI (collectively, "the TCW claims"). Finally, BSI also brought one claim—for expungement of E & Y's Proof of Claim—as the assignee of an objection to E & Y's Proof of Claim filed by the Official Unsecured Creditors' Committee ("Creditors' Committee"). On April 5, 2000, the bankruptcy court granted judgment for BSI on six of its seven claims, see *Bankr. Servs., Inc.* v. *Ernst & Young* (*In re CBI Holding Co.*), ("*CBI I*" or "Bankruptcy Opinion"), 247 B.R. 341 (Bankr. S.D.N.Y. 2000), and later awarded BSI approximately $70 million in damages. In two orders entered on June 30, 2004, see *Ernst & Young* v. *Bankr. Servs., Inc.* (*In re CBI Holding Co.*) ("*CBI II*" or "June Order"), 311 B.R. 350 (S.D.N.Y. 2004), and October 25, 2004, see *Ernst & Young* v. *Bankr. Servs., Inc.* (*In re CBI Holding Co.*) ("*CBI III*" or "October Order"), 318 B.R. 761 (S.D.N.Y. 2004), the United States District Court for the Southern District of New York (Wood, J.)[1] va-

[1] The Honorable Kimba M. Wood of the United States District Court for the Southern District of New York became Chief

cated the judgment of the bankruptcy court, and directed judgment in E & Y's favor, on the grounds that: (1) the fraudulent acts of CBI's management must be imputed to the company itself, thereby depriving BSI of standing to press the CBI claims; and (2) BSI lacks standing to assert the TCW claims under *Barnes* v. *Schatzkin*, 215 A.D. 10, 212 N.Y.S. 536 (1st Dep't 1925). BSI appeals from each of these grounds. We agree and reverse.

We hold that BSI has standing to assert the CBI claims under the so-called "adverse interest" exception to the normal rule that a claim against a third party for defrauding a corporation with the cooperation of its management accrues to creditors rather than to the guilty corporation. The bankruptcy court's finding that CBI's management "was acting for its own interest and not that of CBI" is not clearly erroneous and constitutes the "total abandonment" of a corporation's interests necessary to satisfy the adverse interest exception. We also hold that BSI has standing to assert the TCW claims because revisions to the bankruptcy laws have undermined the rationale of *Barnes* for the reasons set forth in *Semi-Tech Litigation, L.L.C.* v. *Ting*, 13 A.D.3d 185, 787 N.Y.S.2d 234 (1st Dep't 2004).

Because we reverse, we must reach the two arguments that E & Y raises in its cross-appeal: (1) BSI's claims are not "core proceedings" that may be adjudicated by a bankruptcy judge; and (2) E & Y is entitled to a jury trial on all of BSI's claims. We reject both arguments. We hold that all of the claims pressed by BSI—both the CBI claims and the TCW claims—are "core proceedings," because they are cov-

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Judge on August 1, 2006.

ered by the language of 28 U.S.C. § 157(b) and are integrally related to the Proof of Claim that E & Y voluntarily submitted against the estate. Similarly, we hold that while both parties now agree that E & Y is entitled to a jury trial on the TCW claims, E & Y waived its right to a jury trial on the CBI claims when it submitted its Proof of Claim against the estate and subjected itself to the equitable powers of the bankruptcy court. Moreover, under the rule announced by the Supreme Court in *Katchen* v. *Landy*, 382 U.S. 323 (1966), there is no need to vacate the portions of the bankruptcy court's judgment which relate to the CBI claims merely because the portions of the judgment which relate to the TCW claims have been vacated to allow for a jury trial.

BACKGROUND

I.[2]

The parties. CBI was a large wholesale distributor of pharmaceutical products. Its business consisted primarily of purchasing pharmaceutical products from manufacturers and warehousing those products for delivery to entities such as retail pharmacies and hospitals, which in turn sold the products to end users. CBI's President and Chairman was Robert Castello. Castello had an employment agreement with CBI in which he was eligible for an annual bonus in an amount tied to the company's net earnings.

To remain competitive, CBI undertook in the early 1990s a strategy of growth by acquisition. It fi-

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[2] The bulk of this section derives from the bankruptcy court's findings of fact. See *CBI I*, 247 B.R. at 347-62, for further details.

nanced these acquisitions in two ways. First, it borrowed capital from a bank syndicate through a series of lending agreements. These agreements included specific financial targets—including an earnings to fixed charge ratio, a net worth ratio and other standard covenants—that CBI had to meet in order to be eligible for additional credit and to avoid default on its existing loans. Moreover, the agreements limited the credit available to each subsidiary of CBI in terms of actual dollars and as a fixed percentage of inventory and accounts receivable. To monitor attainment of the specified targets, the banks required CBI to provide an array of monthly, quarterly, semiannual and annual reports detailing the company's earnings, inventory and receivables, and to certify in connection therewith its compliance with the agreements' various covenants. Second, it acquired capital from TCW, which invested in CBI in May 1991 and again in April 1993. In May 1991, TCW invested $20 million in exchange for $5 million in CBI common stock and $15 million in corporate notes. As a result of this investment, TCW acquired 48% of CBI, while Castello retained 52% of the company. In April 1993, TCW invested an additional $750,000 in CBI in exchange for a note with a face value of $750,000 and $250,000 worth of CBI common stock.

Through its initial investment, TCW also acquired various rights set forth in a shareholders agreement (the "Shareholders Agreement") and a securities purchase agreement (the "Securities Agreement"). Most importantly, TCW acquired the right to select two of the five members of CBI's Board of Directors and one of the three members of the Board's Audit Committee, while Castello retained the Presidency and Chairmanship of CBI as well as the right to select the Board's and Audit Committee's remain-

ing members. TCW's two seats on the Board were filled by Frank Pados and, by 1993, Brian Mahoney.

TCW also acquired the right to take control of CBI in the event of the occurrence of a "control triggering event." The Shareholders Agreement defined control triggering events to include (1) a breach of the earnings to fixed charge ratio specified in the Securities Agreement, and (2) a failure to pay the principal on TCW's corporate notes, whether such payment was due at maturity or by reason of acceleration. The Securities Agreement permitted TCW to accelerate CBI's note payment schedule in the event of certain defaults, including the making of any unauthorized loan to a CBI officer (e.g., Castello).

E & Y became CBI's independent auditors in June 1990. E & Y performed audits of CBI's financial statements for fiscal years 1990 to 1993, and in 1994 began a re-audit of CBI's 1993 financial statements. In addition to serving as independent auditors, E & Y also received substantial fees for performing supplemental mid-year reviews and due diligence procedures related to CBI's acquisitions.

The fraud. It is undisputed that Castello and certain other members of CBI's management engaged in a scheme to deceive the company's lenders, including TCW, as to CBI's true financial condition during fiscal years 1992 and 1993. The fraudulent scheme consisted primarily of inventory fraud, which took three principal forms.

First, CBI's management delayed the recording of invoices—that is, CBI's management intentionally failed to record invoices during the fiscal year in which purchases were made and/or goods were received. Since CBI had to continue to pay its vendors

in order to continue to receive merchandise, management would round up the amounts owed as payments to the vendors and classify the amounts paid as "advance" payments. Advance payments are usually considered assets and recorded as such on the balance sheet, but E & Y's work papers indicate that the advance payments were treated as reductions to "accounts payable." Because the invoices were never recorded as accounts payable on CBI's balance sheet, the scheme reduced accounts payable twice: once when the invoice was not added to accounts payable, and once when the amount actually paid was subtracted from accounts payable as an "advance." Additionally, the inventory to which these invoices pertained was apparently included on the balance sheet as assets. It is undisputed that this aspect of the scheme helped CBI generate falsely inflated earnings, which, in turn, improved the company's earnings to fixed charge ratio (preventing default on the bank loans and on the TCW loan) and inflated Castello's bonus.

Second, CBI's management created fictitious inventory, which was then included in the calculation of the company's total assets. This aspect of the scheme increased the amount of inventory available as collateral for CBI's bank loans, thus increasing the amount of money that CBI was able to borrow from the banks, and may also have affected the company's earnings.

Third, CBI's management engaged in "paper" transfers of inventory between subsidiaries—that is, when a subsidiary of CBI reached the borrowing limit on its bank loans given its actual inventory, CBI's management would falsely indicate that inventory had been transferred from other subsidiaries

which had more inventory, in order to allow the maxed out subsidiary to continue to borrow. This aspect of the fraud had no effect on CBI's consolidated financial statements, but allowed CBI's subsidiaries to skirt the loan agreements' borrowing caps.

Castello also defrauded CBI with regard to his annual bonuses. He took a bonus based on CBI's falsely inflated net earnings for fiscal year 1992, which he knew was greater than that to which he was entitled. He also took a portion of his falsely inflated bonus for fiscal year 1993 prior to entitlement.

The question at the heart of this appeal is whether the above-described fraudulent scheme was intended solely to benefit its perpetrators personally or whether those perpetrators also had CBI's interests in mind.

The audits. E & Y issued unqualified audit opinions with respect to CBI's financial statements for fiscal years 1992 and 1993 on August 6, 1992 and October 26, 1993, respectively. For both of those years, E & Y's opinions stated that E & Y conducted its audit in accordance with Generally Accepted Accounting Standards ("GAAS") and that, in the opinion of E & Y, the consolidated financial statements presented fairly, in all material respects, the financial position of CBI. In fact, the financial statements prepared by E & Y did not fairly present CBI's financial position because E & Y did not detect certain unrecorded liabilities when it performed the audits. In March 1994, E & Y acknowledged that CBI's 1993 financial statements were materially inaccurate and withdrew its October 23, 1993 opinion. Also in March 1994, E & Y commenced additional procedures related to the financial statements of CBI for fiscal year 1993 (the "re-audit"). E & Y never completed

the re-audit; in July 1994, CBI directed it to cease all audit-related activities.

II.

The bankruptcy proceeding. In August 1994, CBI filed voluntary petitions for relief under Chapter 11 of the Bankruptcy Code. In January 1995, E & Y filed a Proof of Claim against CBI in those proceedings in the amount of $210,850 for allegedly unpaid auditing and consulting services. The Proof of Claim states that the claim "arises from professional services rendered in 1993 and 1994 on behalf of [CBI] in connection with the audit of [CBI]'s financial statements and other special engagements." In June 1995, the Creditors' Committee filed an Objection to certain claims filed in CBI's bankruptcy action, including E & Y's claim. The objection does not allege malpractice, but states that it is "without prejudice to the Committee's right to object to the within proofs of claim on other grounds as may be necessary."

By order dated August 23, 1995, the bankruptcy court confirmed the First Amended Joint Plan of Reorganization of Creditors' Committee and CBI. Pursuant to the Plan, Castello's equity interest in CBI was extinguished, and BSI was appointed Disbursing Agent for the Debtors' estates and charged with the responsibility of distributing the estates' assets to their creditors. CBI also granted BSI "the right to pursue and prosecute * * * all adversary proceedings and contested matters pending or thereafter commenced or filed in the Bankruptcy Court or elsewhere, including * * * any and all objections to claims." The Plan also contained a settlement of the potential claims between CBI and TCW: TCW was granted an allowed claim of $16.7 million against the estates; CBI was "deemed to have waived and re-

leased any and all claims * * * against TCW"; and TCW "transferred and assigned to the Disbursing Agent, any and all rights to pursue and prosecute causes of action of any kind held by TCW against any third party, in its capacity as a Creditor or equity security holder of any of the Debtors."

On October 25, 1996, the Creditors' Committee and BSI entered into an assignment under which the Creditors' Committee expressly assigned to BSI its "right, title and interest to pursue and prosecute all adversary proceedings and contested matters pending as of the Effective Date of the Plan or thereafter commenced or filed in the Bankruptcy Court or elsewhere including, without limitation, the Litigations and objections to claims, inclusive of the Objection to the claim of E & Y."

The adversary proceeding. On October 16, 1996, BSI, in its capacity as the Disbursing Agent under the Plan, filed a complaint in bankruptcy court against E & Y. On October 25, 1996—after the express assignment of the Creditors' Committee claims—BSI filed an amended complaint concerning the professional services rendered by E & Y to CBI from 1992 to 1994. Specifically, the amended complaint alleges: (1) breach of contract in connection with the fiscal 1992 and 1993 audits; (2) negligence in connection with the fiscal 1992 and 1993 audits; (3) negligent misrepresentation that the fiscal year 1992 and 1993 financial statements were materially accurate and that E & Y conducted the fiscal 1992 and 1993 audits in compliance with GAAS; (4) fraud and/or recklessness in connection with the fiscal 1992 and 1993 audits; (5) fraud and/or recklessness in inducing Debtors to retain E & Y to perform the re-audit; (6) breach of fiduciary duty in failing to

make certain disclosures to CBI; and (7) expungement of E & Y's $210,850 Proof of Claim. BSI brought each of the seven claims as the successor to the claims of CBI under the Plan. BSI also brought the second, third, fourth and fifth claims as assignee of the claims that TCW acquired as a creditor of CBI, pursuant to the settlement contained in the Plan. Finally, BSI also brought the seventh claim as the assignee of the Creditors' Committee's Objection.

Soon after BSI filed its amended complaint, E & Y moved to withdraw the adversary proceeding from bankruptcy court to the United States District Court for the Southern District of New York (Wood, J.). By order dated November 13, 1998 ("1998 Order"), the district court denied that motion, concluding that the adversary proceeding qualified as a "core proceeding" under 28 U.S.C. § 157(b)(2), and specifically as a "counterclaim" under § 157(b)(2)(C) and as a proceeding concerning the "allowance or disallowance of claims against the estate" under § 157(b)(2)(B). The court based that conclusion on its determination that the Proof of Claim and the claims in the amended complaint "are related, arise out of the same transaction, and a determination of [BSI's] claims would likely be dispositive of E & Y's claims." The court also found that the claims were core proceedings under the "catch-all" provisions of § 157(b)(2)(A) ("matters concerning the administration of the estate") and (O) ("other proceedings affecting the liquidation of the assets of the estate or the adjustment of the debtor-creditor or the equity security holder relationship, except personal injury tort or wrongful death claims"). On August 13, 1999, the court denied E & Y's motion for re-argument and reconsideration of its order.

On May 4, 1999, BSI withdrew the demand for a jury trial contained in its amended complaint; the next day, E & Y filed its answer to that complaint and demanded a jury trial. On September 3, 1999, the bankruptcy court held that E & Y had waived its right to a jury trial when it "voluntarily participated in the equitable reordering of [CBI's] estates by filing a proof of claim," because all of the claims BSI presses against E & Y "are an 'inextricable part' of the allowance or disallowance of E & Y's claim against the[ ] estates and the adjustment of the debtor-creditor relationship."

The bankruptcy court's opinion. On April 5, 2000, after a seventeen-day bench trial on the issue of liability, the bankruptcy court granted judgment for CBI on its first through fifth and seventh claims.[3] *CBI I*, 247 B.R. at 369. The court's opinion does not discuss each of BSI's claims separately, but concludes that: E & Y departed from GAAS, the accepted standards of practice for auditors, in conducting the fiscal year 1992 and 1993 audits of CBI's financial statements; and that E & Y's departure was the proximate cause of injury to CBI and TCW. See *id.* at 362-64. The court also rejected each of the four grounds on which E & Y moved to dismiss (some or all of) BSI's claims, holding that: (1) the imputation

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[3] The bankruptcy court previously dismissed BSI's sixth claim, for breach of fiduciary duty. *CBI I*, 247 B.R. at 346. The court did not specifically mention BSI's seventh claim for expungement of E & Y's Proof of Claim in its opinion, but noted that it granted judgment for CBI "on all remaining counts." See *id.* at 369. Moreover, in its November 6, 2000 judgment, the bankruptcy court stated that it found "with respect to Count VII[,] that [E & Y's] proof of claim in the bankruptcy proceeding in the amount of $210,850 should be expunged."

doctrine does not deprive BSI, as the successor in interest of CBI, of standing to assert its claims against E & Y; (2) the relationship between E & Y and TCW was close enough for TCW (and BSI acting on TCW's behalf) to assert negligence-based claims against E & Y (and, alternatively, that TCW would have standing to assert a common law fraud claim); (3) BSI's claims are not barred under New York's three-year statute of limitations; and (4) the TCW claims are not barred by New York General Obligations Law § 15-108(c). See *id.* at 364-69.

The court rejected E & Y's "imputation defense"—that "as the successor in interest to CBI," BSI lacks standing to pursue the CBI claims "because the knowledge of certain CBI officers * * * who were involved in the * * * fraud must as a matter of law be imputed to CBI itself and would therefore bar CBI from contending that it was deceived by the erroneous financial statements that E & Y certified"—on two grounds. See *id.* at 364-65.

First, the court concluded that although management's knowledge is usually imputed to the company itself, BSI still had standing to press the CBI claims under the widely accepted "adverse interest" exception to such imputation. *Id.* at 365 (citing *Sec. Investor Prot. Corp.* v. *BDO Seidman LLP*, 49 F. Supp. 2d 644, 650-51 (S.D.N.Y. 1999)). The court explained that "the knowledge of company management involved in a fraud will not be imputed to the company itself if such management was acting totally for its own interest and not that of the corporation." *Id.* The court reasoned that because "as demonstrated in the Findings of Fact, the evidence showed that the fraud was perpetrated for the purpose of obtaining a bigger bonus for Castello, and to

preserve Castello's personal control over the company," management's knowledge should not be imputed to CBI "because the segment of management involved in the fraud was acting for its own interest and not that of CBI." *Id.* Although the court did not identify on which factual findings it based this conclusion, earlier in its opinion, under the heading "Facts Bearing on Inapplicability of Doctrine of Imputation," it found as a matter of fact that "[a] principle [sic] reason why * * * members of CBI management caused liabilities to remain unrecorded at year-end was not for any corporate purpose but rather to ensure that Castello received the maximum possible bonus and remained in control." *Id.* at 360.

Second, the court endorsed another exception to the normal rule of imputation, the so-called "innocent insider" exception, see *id.* at 364-65, recognized by a number of courts in the Southern District of New York, see, *e.g.*, *Wechsler* v. *Squadron, Ellenoff, Plesent & Sheinfeld, LLP*, 212 B.R. 34, 35-36 (S.D.N.Y. 1997). The court explained that "a corporation whose management was involved in an accounting fraud is not barred from asserting claims for professional malpractice in not detecting the fraud, provided the corporation had at least one decision-maker in management or among its stockholders who was innocent of the fraud and could have stopped it." *CBI I*, 247 B.R. at 364-65 (citing *BDO Seidman*, 49 F. Supp. 2d at 649-51). Referring to its earlier findings of fact, the court reasoned that because "TCW was innocent of the fraud, and one of its representatives on CBI's board of directors, Frank Pados, testified that had he known of the fraud, he would have taken steps to stop it[,] * * * the wrongdoing on the part of CBI's management is not imputable to CBI itself." *Id.* at 365.

The court also rejected E & Y's claim that its relationship with TCW was not close enough to permit TCW to hold it responsible for any of its negligence or fraud with respect to CBI's financial statements. *Id.* at 365-66. The court explained that, under New York law, three criteria "must be met in order to hold accountants liable in negligence to non-contractual parties who rely to their detriment on inaccurate financial reports:"

> "(1) the accountants must have been aware that the financial reports were to be used for a particular purpose or purposes; (2) in the furtherance of which a known party or parties was intended to rely; and (3) there must have been some conduct on the part of the accountants linking them to that party or parties, which evinces the accountants' understanding of that party or parties' reliance."

Id. at 366 (quoting *Credit Alliance Corp.* v. *Arthur Andersen & Co.*, 65 N.Y.2d 536, 551, 493 N.Y.S.2d 435, 483 N.E.2d 110 (1985)). The bankruptcy court then recounted seven of its findings of fact that it concluded "demonstrated * * * [that] each of the Credit Alliance factors was satisfied" in the instant case. *Id.* The court also held that "even if the Credit Alliance factors had not been met, TCW would still have standing to assert a claim based on a theory of common law fraud." *Id.*

By order dated April 18, 2000, the bankruptcy court scheduled a trial on damages. After a second bench trial, the bankruptcy court determined damages of $27,738,603, plus pre-judgment interest of nearly $17,000,000, with respect to the CBI claims, and damages of $15,412,000, plus pre-judgment in-

terest of nearly $10,000,000, with respect to the TCW claims. The court found the appropriate measure of damages suffered by CBI to be the difference in the amount for which its equity could have been sold in 1993 and $0 (CBI's value at the time the Plan was entered on August 23, 1995). The court found the appropriate measure of damages suffered by TCW (as a creditor of CBI) to be the amount it would have received on its $15.75 million in notes if CBI had been sold in October 1993.

The district court's orders. E & Y appealed the bankruptcy court's decision to the United States District Court for the Southern District of New York (Wood, J.) on a number of grounds. On June 26, 2004, the district court issued an opinion and order affirming in part and reversing in part the decision of the bankruptcy court. *CBI II*, 311 B.R. at 355. The court affirmed the bulk of the bankruptcy court's decision, including: the basis of its jurisdiction (which relied on the district court's conclusion in its 1998 Order that the CBI and TCW claims were all core), see *id.* at 362-63; its finding that E & Y waived its right to a jury trial on the CBI claims, see *id.* at 365-66; its finding that BSI has standing to assert CBI's negligence and breach of contract claims notwithstanding E & Y's imputation defense, see *id.* at 373-76; its finding that BSI has standing to assert TCW's fraud claim, see *id.* at 376; and its rejection of E & Y's other affirmative defenses, see *id.* at 377. However, the district court reversed the bankruptcy court's finding that E & Y was not entitled to a jury trial with respect to the TCW claims. See *id.* at 366-67. As a result of that reversal, the district court pointed out that BSI had standing to assert TCW's negligence claims only if a jury found (as the bankruptcy court had) that the Credit Alliance factors

were satisfied.[4] See *id.* at 376. The court also ordered the parties to provide additional briefing on whether its conclusion that E & Y is entitled to a jury trial on the TCW claims necessitates a new trial on the CBI claims as well. *Id.* at 377-78. The court indicated that the resolution of that question would render moot some, if not all, of the outstanding issues on appeal. *Id.*

The district court declined to resolve the question of whether BSI has standing to assert CBI's fraud claims in light of E & Y's proffered imputation defense. *Id.* at 377. The court explained that, "[t]he bankruptcy court's decision states a number of times that the segment of management involved in the fraud was acting in its own interest and not acting in CBI's interest," and that "[t]he bankruptcy court stated, specifically, that the purpose of the fraud was to obtain a bigger bonus for Castello, and to preserve Castello's personal control over CBI." *Id.* at 370. The district court concluded that, "[t]hese statements * * * support the bankruptcy court's conclusion that the adverse interest exception applies, and that imputation is therefore inappropriate." *Id.* However, the court expressed some reservations regarding the language utilized by the bankruptcy court:

> [I]n its findings of fact, the bankruptcy court suggested (perhaps inadvertently) that there existed at least one purpose for the fraud other than to obtain a bigger bonus for Castello, and to preserve Castello's personal control over CBI: The bankruptcy court stated in its findings of fact that "[a] principle [sic]

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[4] As noted before, the court agreed with the bankruptcy court that BSI could assert TCW's fraud claims against E & Y.

> reason why * * * members of management caused liabilities to remain unrecorded at year-end was not for any corporate purpose but rather to ensure that Castello received the maximum bonus and remained in control." This language leaves open the possibility that the bankruptcy court found that some corporate purpose was served by the fraud.

Id. (internal citation omitted and alterations in original). However, the court did explicitly "decline[ ] to adopt any innocent insider exception" to the normal rule of imputation, because "misconduct by those given authority to make decisions on behalf of a company should be imputed to the company even if innocent members of management could and would have prevented the fraud had they been aware of it." *Id.* at 372.

On July 8, 2004, E & Y filed a motion for rehearing, in which it asked the district court: to rule on the previously unresolved question of whether BSI has standing to assert CBI's fraud claims under the adverse interest exception to imputation; to reconsider its earlier holdings that BSI has standing to assert CBI's negligence and breach of contract claims, and TCW's fraud claims; and to rule on the question—previously deferred to a jury—of whether BSI has standing to assert TCW's negligence claims. On October 26, 2004, the district court granted the motion for rehearing, resolved each of the four issues raised in E & Y's motion in defendants' favor, vacated in full the judgment of the bankruptcy court, and directed the clerk of the court to enter final judgment in favor of E & Y. *CBI III*, 318 B.R. at 763, 767.

In holding that BSI lacks standing to assert CBI's fraud claims against E & Y, the district court reversed the bankruptcy court's conclusion that "CBI's managers 'totally abandoned' CBI's interests" when they committed their fraudulent acts on four grounds. *Id.* at 763-65. In so doing, the district court gave no indication that it was according the bankruptcy court's factual finding any deference.

First, the district court criticized the sufficiency of the evidence that the bankruptcy court cited in support of its finding of total abandonment:

> The exhibit upon which [the bankruptcy court] relie[d] is a vaguely worded schedule regarding the financial scenario that would need to occur "to reach 100 percent of bonus." The text of the exhibit was found by an [E & Y] employee, on the computer used by John O'Brien, the former Controller of CBI. Although BSI and the Bankruptcy Court below treat this document as evidence of the intention of CBI's managers in defrauding the company, [E & Y] correctly points out here that the Bankruptcy Court declined to admit this document for that purpose, because the document was not authenticated. There is no testimony by O'Brien concerning the document; there is no indication of who created the document and for what purpose it was created. There is thus no basis to conclude that the document provides any evidence of O'Brien's intent in participating in the scheme to defraud CBI.

Id. at 764 (internal citations and footnotes omitted).

Second, the court discredited the testimony of Brian Mahoney, a former accounting supervisor at CBI, which BSI pointed to as other record evidence supporting the bankruptcy court's finding. The gist of Mahoney's testimony was that "[John] O'Brien told him that the 'real reason' for failing to record liabilities and for overstating CBI's income was to ensure that Castello received his maximum bonus." *Id.* at 764-65. The district court explained that "[e]ven if Mahoney's testimony, which is clearly hearsay, were admissible as an exception to the hearsay rule, its probative value is slight, in view of Mahoney's testimony immediately thereafter that he had no way of knowing whether O'Brien had some other purpose in mind for failing to record liabilities." *Id.* at 765.

Third, the district court held that the bankruptcy court should have drawn an adverse inference "from the fact that BSI chose not to offer any testimony by Paul Rogers, CBI's former senior financial officer," because Rogers, "allegedly a central figure in the fraud, * * * [who] possessed first-hand knowledge about the 'real reason(s)' for the fraud," was available as a witness to CBI via his court approved settlement agreement. *Id.*

Finally, following its own review of the record, the court found "some evidence that various corporate purposes were served by the managers' acts of fraud" besides inflating Castello's bonus. *Id.* For instance, the court found that "CBI's managers hid invoices and left certain liabilities unrecorded in order to give false representations of CBI's profitability to lending banks, without which CBI would have risked triggering an event of default." *Id.*

The district court then reversed its earlier holding that, "regardless of whether BSI has standing to

sue [E & Y] for defrauding CBI, BSI has standing to assert CBI's negligence and breach of contract claims" on the grounds that because "[t]he factual allegations giving rise to CBI's negligence and breach of contract claims are virtually identical to the allegations giving rise to CBI's fraud claims[,] * * * [t]he claims assert 'a single form of wrongdoing under different names' for purposes of the standing analysis." *Id.* at 765-66.

Finally, the court reversed its earlier holding that BSI had standing to assert TCW's claims on the grounds that it had "overlooked controlling law, which holds that a bankruptcy trustee does not have standing to assert claims against third parties on behalf of creditors of a corporation, even where the creditors assigned their claims to the trustee." *Id.* at 766 (citing *Breeden* v. *Kirkpatrick & Lockhart LLP* (*In re Bennett Funding Group, Inc.*) ("Bennett"), 336 F.3d 94, 102 (2d Cir. 2003)). *Bennett*, the case cited by the district court for this proposition, cites in turn to a line of cases that originates with *Barnes* v. *Schatzkin*, 215 A.D. at 10, 212 N.Y.S. 536. *Bennett*, 336 F.3d at 102. The court reasoned that because the Second Circuit has consistently followed *Barnes* and BSI has been treated as analogous to a bankruptcy trustee throughout these proceedings, BSI does not have standing to assert claims on behalf of TCW. *CBI III*, 318 B.R. at 767.

DISCUSSION

BSI now presses two main arguments on appeal. First, BSI argues that it has standing to assert the CBI claims, because the district court erred in finding the adverse interest and innocent insider exceptions inapplicable, and therefore in imputing the fraudulent acts of members of CBI's management to

CBI. BSI argues that, in the alternative, its claims based on E & Y's conduct in connection with the 1994 re-audit are meaningfully distinct from its claims based on management's fraud, and therefore it has standing to assert the re-audit claims even if management's wrongdoing is imputed to CBI. Second, BSI argues that it has standing to assert the TCW claims because *Barnes* is no longer good law and is distinguishable from the instant case. We agree that BSI has standing to assert all of CBI's claims under the adverse interest exception to the normal rule of imputation. Thus, we need not address BSI's arguments regarding the innocent insider exception and the 1994 re-audit.[5] We also agree that BSI has standing to assert the TCW claims. To the extent that *Barnes* interprets federal law, it is not binding on this Court. We find that, in light of the subsequent inclusion of § 541(a)(7) in the Bankruptcy Code, *Barnes'* reasoning is no longer persuasive. We therefore must reach the two arguments that E & Y presses on cross-appeal: first, that none of BSI's claims are core proceedings that may be adjudicated by a bankruptcy judge; and, second, that the district court erred in holding that E & Y was not entitled to a jury trial on the CBI Claims. We reject both.

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[5] Judge Wood's analysis of the innocent insider exception and its likely genesis as a product of courts' confusion regarding the relationship between the normal rule of imputation, the adverse interest exception to that rule, and the sole actor exception to that exception is extremely persuasive. See *CBI II*, 311 B.R. at 372-73; see also Jonathan Witmer-Rich & Mark Herrmann, *Corporate Complicity Claims: Why There is No Innocent Decision-Maker Exception to Imputing an Officer's Wrongdoing to a Bankrupt Corporation*, 74 Tenn. L. Rev. 47, 59-80 (2006).

I.

Does BSI have standing to assert the CBI claims against E & Y notwithstanding the role CBI's management played in the fraud? Under New York law, "[a] claim against a third party for defrauding a corporation with the cooperation of management accrues to creditors, not to the guilty corporation." *Shearson Lehman Hutton, Inc.* v. *Wagoner*, 944 F.2d 114, 120 (2d Cir. 1991). Because a bankruptcy "trustee stands in the shoes of the bankrupt corporation" and can maintain only those actions that the debtors could have brought prior to the bankruptcy proceedings, "when a bankrupt corporation has joined with a third party in defrauding its creditors, the trustee cannot recover against the third party for the damage." *Id.* at 118; see also *Mediators, Inc.* v. *Manney* (*In re The Mediators, Inc.*), 105 F.3d 822, 826 (2d Cir. 1997) (applying same analysis to creditors committee "suing on behalf of the debtor").

"[B]reach of contract, negligence, and fraud, when committed by auditors, are a single form of wrongdoing under different names," and therefore, under the logic of *Wagoner*, a bankruptcy trustee does not have standing to bring any claims related to professional malpractice in the context of cooperative wrongdoing between the debtor and its auditors. *Cenco Inc.* v. *Seidman & Seidman*, 686 F.2d 449, 453 (7th Cir. 1982)); see also *Wedtech Corp.* v. *KMG Main Hurdman* (*In re Wedtech Corp.*), 81 B.R. 240, 241 (S.D.N.Y. 1987) (reaching this conclusion in the context of claims brought under New York law). Thus, in *Hirsch* v. *Arthur Andersen & Co.*, 72 F.3d 1085 (2d Cir. 1995), we held that a trustee lacked standing to sue a bankrupt corporation's auditors "for professional malpractice on the basis that activi-

ties undertaken by the[ ] [auditors] to effectuate * * * scheme[s aimed at defrauding creditors] also impacted adversely upon" the corporation, where the corporation collaborated with the auditors "in promulgating and promoting the * * * schemes." *Id.* at 1094 (applying the *Wagoner* rule under Connecticut law).

"The rationale underlying the *Wagoner* rule derives from the fundamental principle of agency that the misconduct of managers within the scope of their employment will normally be imputed to the corporation." *Wight* v. *BankAmerica Corp.*, 219 F.3d 79, 86 (2d Cir. 2000). This principle is itself based "on the presumption that an agent [will normally] discharge[ ] his duty to disclose to his principal all the material facts coming to his knowledge with reference to the subject of his agency," and thus any misconduct engaged in by a manager is with—at least—his corporation's tacit consent. *Center* v. *Hampton Affiliates, Inc.*, 66 N.Y.2d 782, 784, 497 N.Y.S.2d 898, 488 N.E.2d 828 (1985) (internal quotation marks omitted). "Under New York law, the adverse interest exception rebuts th[is] usual presumption * * * ." *Mediators*, 105 F.3d at 827. "Under the exception, management misconduct will not be imputed to the corporation if the officer acted entirely in his own interests and adversely to the interests of the corporation." *Wight*, 219 F.3d at 87. The theory is that "when an agent is engaged in a scheme to defraud his principal, either for his own benefit or that of a third person, * * * he cannot be presumed to have disclosed that which would expose and defeat his fraudulent purpose." *Center*, 66 N.Y.2d at 784, 497 N.Y.S.2d 898, 488 N.E.2d 828 (citations omitted). However, New York courts have cautioned that this exception is a narrow one and that the guilty man-

ager "must have totally abandoned" his corporation's interests for it to apply. *Id.* at 784-85, 497 N.Y.S.2d 898, 488 N.E.2d 828.

There is no dispute that, if the *Wagoner* rule applies, BSI lacks standing to assert CBI's claims against E & Y for fraud, negligence and breach of contract in connection with its 1992 and 1993 fiscal audits. Members of CBI's management committed various acts of fraud that E & Y failed to uncover during the two audits. If the acts of those individuals, and the knowledge of the fraud possessed by those individuals, can be imputed to CBI itself, then BSI—standing in CBI's shoes—cannot sue E & Y for its role in the fraud. Thus, the parties' dispute focuses solely on whether any exception to the Wagoner rule bars such imputation. We find that the adverse interest exception is satisfied, and thus that BSI has standing to pursue the CBI claims.

A.

Our review of orders issued by a district court "in its capacity as an appellate court is plenary." *Giaimo* v. *DeTrano* (*In re DeTrano*), 326 F.3d 319, 321 (2d Cir. 2003). "The factual determinations and legal conclusions of the Bankruptcy Court are, therefore, reviewed independently by this Court." *Denton* v. *Hyman* (*In re Hyman*), 502 F.3d 61, 65 (2d Cir. 2007). The bankruptcy court's factual conclusions are reviewed for clear error, while its legal conclusions are reviewed de novo. *Id.*

A factual finding is not clearly erroneous unless "the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed." *United States* v. *U.S. Gypsum Co.*, 333 U.S. 364, 395 (1948). Notwithstanding Ap-

pellees' contention to the contrary, in reviewing factual findings for clear error, an appellate court is not confined to evidence cited in a lower court's opinion, but must instead review all of the record evidence. *Anderson* v. *City of Bessemer City, N.C.*, 470 U.S. 564, 575 (1985); see also *Krieger* v. *Gold Bond Bldg. Prods.*, 863 F.2d 1091, 1098 (2d Cir. 1988).

B.

The bankruptcy court's conclusion that "the [imputation] doctrine [is] rendered inapplicable by virtue of the 'adverse interest' exception because the segment of management involved in the fraud was acting for its own interest *and not that of CBI*" was based on its factual finding that "the fraud was perpetrated for the purpose of obtaining a bigger bonus for Castello, and to preserve Castello's personal control over the company" and its legal understanding that "[u]nder the 'adverse interest' exception, the knowledge of company management involved in a fraud will not be imputed to the company itself if such management was *acting totally for its own interest and not that of the corporation*." *CBI I*, 247 B.R. at 365 (emphasis added). This explanation leaves no doubt that the bankruptcy court concluded *as a matter of fact* that CBI's management had totally abandoned CBI's interests as required for the "adverse interest" exception to be satisfied, see *id.* at 360, notwithstanding the muddled "principle [sic] reason" language highlighted by the district court, see *CBI II*, 311 B.R. at 370. Thus, the only question is whether the bankruptcy court's factual finding of total abandonment is clearly erroneous. See *Hyman*, 502 F.3d at 65. We conclude that it is not.

The most important piece of record evidence that supports the bankruptcy court's finding is Mahoney's

testimony. Mahoney, a former accounting supervisor at CBI, testified that he was told by O'Brien, CBI's former Controller, that "the real reason" for the fraud was to maximize Castello's bonus. He testified that he had multiple conversations over the period of the fraud with O'Brien and Paul Rogers, CBI's former senior financial officer, in which he was instructed as to the exact procedure to follow in order to "overstate" CBI's income to reach the "gross profit percentage" necessary "for Mr. Castello's bonus to be met." His fraudulent activity came only at the direction of O'Brien and Rogers. He also testified that he was "not aware of" any motivations for the fraud besides Castello's bonus.

Appellees argue that the district court was correct to dismiss Mahoney's testimony as lacking in probative value, because "when asked 'whether Mr. O'Brien had other purposes in mind for reaching the gross profit percentage besides the reason he gave you,'" Mahoney testified that he didn't "'know if [O'Brien] had other ideas.'"[6] Thus, Appellees contend that "Mahoney's testimony was completely non-probative on the central question posed by the adverse-interest exception: [D]id the managers *totally* abandon the Company's interests or were they '*si-*

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[6] Although the district court also deemed Mahoney's testimony "clearly hearsay," see *CBI III*, 318 B.R. at 765, Appellees now concede that it is admissible under the rule that "the opponent whose question calls in advance for obviously inadmissible evidence has thereby waived objection to the answer, and he cannot object if the other party subsequently makes use of the very evidence that he has elicited." 1 *Wigmore on Evidence* § 18, at 336 (Chadbourn rev. 1981). E & Y called Mahoney as an adverse witness and asked Mahoney about his conversations with O'Brien and Rogers repeatedly.

multaneously serving their own interests and the company's interests'?"

Mahoney's testimony, however, is clearly probative of this central question: Mahoney, one of the key figures in the scheme, had himself *totally abandoned* CBI's interests when he engaged in the fraudulent activity and was convinced that the rest of the guilty members of CBI's management had done the same. While the bankruptcy court might have elected to infer from Mahoney's testimony that there actually were other reasons for the fraud, it was clearly not required to draw such an inference. "In reviewing findings for clear error, [an appellate court is] not allowed to second-guess * * * the trial court's * * * choice between permissible competing inferences. Even if the appellate court might have weighed the evidence differently, it may not overturn findings that are not clearly erroneous." *Ceraso* v. *Motiva Enters., LLC*, 326 F.3d 303, 316 (2d Cir. 2003) (internal citation omitted). Moreover, given that Appellees provide no evidence that O'Brien had reason to conceal his intention to benefit CBI while revealing his more illicit motive for the fraud, the inference advanced by Appellees has little support in the record.

Indeed, Appellees point to only one piece of direct evidence for the proposition that CBI's management had mixed motives for the fraud: the testimony of Louis Scerra, an auditor at E & Y, regarding a conversation he had with Frank Pados, TCW's principal representative on the CBI Board, in March 1994. In other words, Appellees provide only one piece of evidence that directly contradicts the inference of total abandonment that the bankruptcy court drew from

Mahoney's testimony.[7] Scerra testified that Pados told him that the fraud was designed to "help the company prosper, grow, increase in value." Appellees contend that this testimony is "unchallenged and unrebutted."

However, the bankruptcy court expressly found Scerra's testimony to be "evasive, lacking in credibility, or both." *CBI I*, 247 B.R. at 359. "[W]hen a trial judge's finding is based on his decision to credit the testimony of one of two * * * witnesses, each of whom has told a coherent and facially plausible story that is not contradicted by extrinsic evidence, that finding, if not internally inconsistent, can virtually never be clear error." *Anderson*, 470 U.S. at 575. Thus, to the extent that the bankruptcy court's finding of total abandonment rests on its decision to credit Mahoney's testimony rather than Scerra's, its finding is not clearly erroneous.

Moreover, the record contains external evidence that the bankruptcy court could have interpreted as contradicting Scerra's testimony: the bonus schedule that Scerra found on O'Brien's computer and faxed to Mahoney, a CBI Board member, in April 1994. The schedule shows the "additions" to the various inputs on CBI's balance sheet for April 1993 necessary "to reach 100 percent of bonus." The document was ad-

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[7] The district court found that the bankruptcy judge should have drawn an adverse inference from the fact that BSI did not offer testimony from Rogers, CBI's former senior financial officer, regarding the motivation for the fraud. *CBI II*, 318 B.R. at 765. Appellees do not press this argument on appeal. In any case, application of the missing witness rule by a trial court is subject to an abuse of discretion standard, which the district court failed to apply. See *Felice* v. *Long Island R.R. Co.*, 426 F.2d 192, 194-95 (2d Cir. 1970).

mitted by the bankruptcy court only for the limited purpose of determining what was in Scerra's mind when he faxed it. It is not direct evidence that Castello's bonus motivated CBI's management. However, in keeping with the hearsay-limited purpose of the bonus schedule, the bankruptcy court could have inferred from the fact that Scerra sent the schedule to a member of CBI's Board that Scerra had concluded that the fraud's purpose was to benefit Castello personally. Thus, the court could have concluded that Scerra's testimony—that he had been told nearly a month before he sent the fax that the fraud was actually to benefit CBI—was not credible.

Appellees also echo the district court's conclusion that the "record contains some evidence that various corporate purposes were served by the managers' acts of fraud, at least some of which were distinct from the issue of Castello's bonus." *CBI III*, 318 B.R. at 765. Specifically, Appellees argue that "CBI had a direct interest in deceiving the banks concerning both quarterly and year-end earnings" in order "to avoid a default" and that "the inflated quarterly figures [CBI's management] * * * presented to the banks * * * had no effect on Castello's bonus or control." According to Appellees, "[t]hese facts render[ ] it impossible to find (as New York law requires) that the financial dishonesty was for *no purpose other than* to secure Castello's bonus and maintain his control." This argument fails for at least three reasons.

First, it is important to remember that the "total abandonment" standard looks principally to the intent of the managers engaged in misconduct. See *Capital Wireless Corp.* v. *Deloitte & Touche*, 216 A.D.2d 663, 666, 627 N.Y.S.2d 794 (3d Dep't 1995) ("[T]he issue [is] whether mismanagement of [the

company] was the vehicle by which [the manager] *intended* to advance his own interest or whether it was simply incidental to his continued efforts to retain some economic viability in the company.") (emphasis added). Evidence that CBI *actually benefitted* from CBI's management's fraud does not make the bankruptcy court's finding that CBI's management did not *intend to benefit* the company clearly erroneous. Indeed, even where the purpose of a fraud was to continue a corporation past insolvency in order to give its management time "to resolve [the corporation's] underlying business problems, such a motivation does not * * * necessarily equate to a finding that the fraudulent actors intended to benefit [the corporation] * * * . [A] reasonable trier of fact could conclude that the true motive of the wrongdoers was the preservation of their employment, salaries, * * * and reputations * * * ." *Phar-Mor, Inc.* v. *Coopers & Lybrand* (*In re Phar-Mor, Inc. Sec. Litig.*), 900 F. Supp. 784, 787 (W.D. Pa. 1995); see also *Capital Wireless*, 216 A.D.2d at 666, 627 N.Y.S.2d 794 (finding an issue for trial in applying the adverse interest exception where, although the "fraud generated much needed financing for plaintiff and forestalled its bankruptcy," the wrongdoer might still have totally abandoned the company's interest); *Oppenheimer-Palmieri Fund, L.P.* v. *Peat Marwick Main & Co.* (*In re Crazy Eddie Sec. Litig.*), 802 F. Supp. 804, 818 (E.D.N.Y. 1992) ("The fact that some of the embezzled money was put back into the corporation to help inflate sales and facilitate public offerings is not inconsistent with an abandonment by * * * [m]anagement of the corporation's interest.").

Second, the fraudulent scheme benefitted Castello in at least three ways: (1) by allowing him to maintain control of CBI even after CBI's actual fi-

nancial results and an unapproved loan to Castello would have allowed TCW either to accelerate payment of its notes or to take control of CBI under the Shareholders' Agreement; (2) by avoiding default on CBI's loans from banks and vendors, which would have forced Castello to relinquish control of the company; and (3) by allowing him to collect two bonuses greater than would have been justified by earnings under his contract, one of which was also a prohibited loan because it was taken before he was entitled to it. Notwithstanding Appellees' adamant protests to the contrary, the three principal forms of inventory fraud engaged in by CBI's management helped Castello to secure at least one of these benefits.[8]

The first form of inventory fraud was the delayed recording of invoices. It is undisputed that this aspect of the fraud helped generate falsely inflated earnings for CBI. The inflation of CBI's earnings improved its earnings to fixed charge ratio, which allowed the company to avoid triggering note acceleration or a takeover under its Shareholders' Agreement with TCW, as well as to avoid defaulting on its bank

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[8] Other aspects of the fraud received little attention in the parties' briefs: intentionally recording credits due to customers late in order to increase accounts receivable; artificially reducing the reserve for doubtful accounts; and falsely reporting the age of accounts receivable to the lenders to maintain the required collateral for bank loans. There is also no evidence in the record that any of these forms of fraud benefitted only CBI. Indeed, because the banks limited CBI's credit to a certain percentage of inventory and accounts receivable, like the second and third principal forms of inventory fraud discussed below, the primary effect of these aspects of the fraud would have been to increase CBI's ability to borrow, thus allowing Castello to retain control of the company.

loans. The inflated earnings also increased Castello's bonus.

The second form of inventory fraud was the creation of fictitious inventory. Mahoney testified that the purpose of this aspect of the fraud was to increase the amount of inventory available as collateral for CBI's bank loans. The fictitious inventory was also included in CBI's calculation of its total assets, which may have artificially reduced the cost of goods sold, and thus increased the apparent profit margin. Even if the fictitious inventory did not affect the earnings to fixed charge ratio, it still helped CBI to continue borrowing money from the lending banks and to avoid having its loans called. Had CBI's credit line from the banks been cut off and its loans called, Castello would have lost control of CBI to TCW (one event that triggered note acceleration or a takeover under the Shareholders' Agreement was a failure to pay off the note on schedule) and his fraud would have been exposed.

The third form of inventory fraud was "paper" transfers of inventory between CBI subsidiaries, which allowed those subsidiaries to borrow past their bank-imposed inventory-based loan limits. Again, this aspect of the fraud increased CBI's cash flow, which was essential to Castello retaining control of the company.

Ultimately, it is clear that Appellees' claim that "the inflated quarterly figures * * * had no effect on Castello's bonus or control" ignores the reality of the complicated financial balancing act CBI's management performed to maintain Castello's increasingly tenuous control of CBI. By inflating CBI's quarterly figures, management maintained the veneer of profitability required to keep TCW and the banks at bay.

Inflating CBI's quarterly figures was also a necessary step in the surreptitious creation of the false annual reports necessary for Castello to collect his maximum bonus-after all, it is difficult to imagine how convincing false annual reports could be created from accurate quarterly ones.

Third, the purported "benefits" that Appellees suggest CBI *itself* received as a result of management's machinations are illusory. "A corporation is not a biological entity for which it can be presumed that any act which extends its existence is beneficial to it." *Bloor* v. *Dansker* (*In re Investors Funding Corp. of N.Y. Sec. Litig.*), 523 F. Supp. 533, 541 (S.D.N.Y. 1980). Prolonging a corporation's existence in the face of ever increasing insolvency may be "doing no more than keeping the enterprise perched at the brink of disaster." *Mirror Group Newspapers* v. *Maxwell Newspapers, Inc.* (*In re Maxwell Newspapers, Inc.*), 164 B.R. 858, 869 (Bankr. S.D.N.Y. 1994). Even the "benefit" provided by "further indebtedness"—capital—"may provide an illusory financial cushion that lulls shareholders into postponing the decision to dissolve the corporation" and thus "miss an opportunity to cut their losses." *Allard* v. *Arthur Andersen & Co.*, 924 F. Supp. 488, 494 (S.D.N.Y. 1996) (internal quotation marks omitted). In this case, there is nothing speculative about the opportunity that CBI would have had to "cut its losses": Pados testified as to TCW's willingness to buy out CBI and the bankruptcy court found as a matter of fact that CBI would have sold for almost $28 million as late as October 1993. See *CBI II*, 311 B.R. at 360.

After reviewing the record as a whole, we find that the bankruptcy court's conclusion that "the segment of management involved in the fraud was

acting for its own interest and not that of CBI" is not clearly erroneous. See *CBI I*, 247 B.R. at 365. Because this finding of total abandonment means the adverse interest exception to the Wagoner rule of imputation applies in this case, the guilty managers' acts and knowledge are not imputed to CBI.[9] As a result, BSI has standing to press the CBI claims against E & Y.

II.

While BSI may assert CBI's claims against E & Y, several questions remain. One involves the claims of TCW and a New York case of a distant era: Does BSI have standing to bring the TCW claims against E & Y notwithstanding *Barnes* v. *Schatzkin*, 215 A.D. at 10, 212 N.Y.S. 536?

In *Barnes*, the First Department of New York's Appellate Division held that a bankruptcy trustee could not, under § 70(a) and (e) of the then-existing Bankruptcy Act, take an assignment of a claim from

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[9] Appellees argue that even if the adverse interest exception is satisfied, this court must determine if the "sole actor" rule—an exception to the exception—applies. See *Mediators*, 105 F.3d at 827. "This rule imputes the agent's knowledge to the principal notwithstanding the agent's self-dealing because the party that should have been informed was the agent itself albeit in its capacity as principal." *Id.* Thus, the sole actor rule applies "where the principal and agent are one and the same" or, in the corporate context, where "the principal is a corporation and the agent is its sole shareholder." *Id.* The sole actor rule does not apply in this case because the CBI managers involved in the fraud were not the sole shareholders of the corporation, nor was there any finding that all shareholders were complicit in the fraud. On the contrary, the bankruptcy court found that TCW, which owned 48% of CBI's shares, was innocent of the fraud. *CBI I*, 247 B.R. at 365.

a debtor's creditor against a third party and sue on that claim as a trustee. *Id.* at 10, 212 N.Y.S. 536. The parties agree that BSI's assertion of the TCW claims depends on the type of assignment that *Barnes* forbids. Thus, they agree that if, as the district court found, *Barnes* is still good law in New York and applies to the facts of this case, then BSI lacks standing to assert the TCW claims. Appellant contends, however, that *Barnes* was overruled by the state court's subsequent decision in *Semi-Tech Litigation, L.L.C.* v. *Ting*, 13 A.D.3d at 185, 787 N.Y.S.2d 234.

Both parties misread *Barnes*. Insofar as *Barnes* draws its understanding of the powers of the bankruptcy trustee from the then-existing Bankruptcy Act, it interprets federal—as opposed to state—law. As such, its holding is not binding on this Court. Moreover, much has changed since *Barnes* was decided The now-recognized powers of a bankruptcy trustee to accept and protect property acquired after the commencement of a bankruptcy proceeding have altered the equation. Although not bound by its decision, we agree with the reasoning set forth in *Semi-Tech*: intervening changes to federal bankruptcy law have undermined the rationale of *Barnes*. BSI has standing to assert the TCW claims under § 541(a)(7) of the modern Bankruptcy Code. See 11 U.S.C. § 541(a)(7).

A.

"In a bankruptcy proceeding, state law determines whether a right to sue belongs to the debtor or to the individual creditors." *Mediators*, 105 F.3d at 825 (citing *St. Paul Fire & Marine Ins. Co.* v. *PepsiCo, Inc.*, 884 F.2d 688, 700 (2d Cir. 1989)). Federal

bankruptcy law "places a trustee in the shoes of the bankrupt corporation and affords the trustee standing to assert any claims that the corporation could have instituted prior to filing its petition for bankruptcy." *Id.* at 825-26 (citing 11 U.S.C. §§ 541, 542). Thus, to the extent that *Barnes* determined who owned the claims the trustee sought to assert, it was interpreting state law and its judgment binds us if still in force. Cf. *Statharos* v. *N.Y. City Taxi & Limo. Comm'n*, 198 F.3d 317, 321 (2d Cir. 1999) ("The ruling of an intermediate appellate state court * * * is a datum for ascertaining state law which is not to be disregarded by a federal court unless it is convinced by other persuasive data that the highest court of the state would decide otherwise.") (internal quotation marks omitted and second alteration in original). But insofar as *Barnes* turned on whether the assignment of those claims to the bankruptcy trustee was consistent with the powers of the trustee under federal bankruptcy law, its judgment is not controlling. See *Wojchowski* v. *Daines*, 498 F.3d 99, 110 n. 9 (2d Cir. 2007).

In *Barnes*, the trustee for Cowley, a bankrupt partnership, sued "the defendants, members of the New York Stock Exchange" for "execut[ing] orders for Cowley * * *, knowing them to be conducting a bucket shop, and aid[ing] and abett [ing] in the [partnership's] fraud and * * * conversion." *Barnes*, 215 A.D. at 11, 212 N.Y.S. 536. The trustee sued not on behalf of Cowley, who by the complaint's terms was primarily responsible for the fraud, but on behalf of the partnership's customers who "lost the equities in their several accounts" when Cowley went bankrupt, and who subsequently "assigned their several claims against the defendants to the plaintiff as trustee in bankruptcy of Cowley." *Id.* The defendants

"moved to dismiss the * * * complaint on the grounds that it appears upon the face thereof that the plaintiff has not legal capacity to sue." *Id.* at 10, 212 N.Y.S. 536.

The court granted defendants' motion to dismiss on the grounds that a trustee of a bankrupt partnership had no capacity, under section 70 of the then-existing Bankruptcy Act, to sue on claims assigned to it by customers of the bankrupt. The court noted that, under New York law: "The claims on which the plaintiff seeks to recover were never part of the assets of [the bankrupt] nor did they arise in favor of the plaintiff as trustee in bankruptcy. They belonged to various creditors * * *. The claim pleaded arose, if at all, in favor of 164 * * * customers * * *." *Id.* at 11, 212 N.Y.S. 536. Thus, the court concluded: "If the trustee may take an assignment of these claims he might take an assignment of a claim from any stranger * * *. No such power appears to be given by the Bankruptcy Act." *Id.* at 12, 212 N.Y.S. 536. The court explained:

> A trustee in bankruptcy has only such title and power as given by the Bankruptcy Act. He is a creature of that statute. No serious assertion is made here that [the assigned] claims * * * were property of the bankrupt. They were not assets which passed to the trustee because they belonged to the bankrupt. The [only] causes of action which the trustee has by reason of the Bankruptcy Act, other than such as were property of the bankrupt, are causes of action to recover or follow assets.
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> * * * We are not concerned with a discussion of what might have been put into the Na-

> tional Bankruptcy Act; our concern is only with what it does contain.

Id. at 13, 212 N.Y.S. 536.

The *Barnes* Court's reasoning is quite clear. New York law dictates that claims against a third party for defrauding a debtor's creditors with the help of the debtor accrue to those creditors rather than to the debtor. Thus, Cowley's trustee could not assert Cowley's customers' claims against the members of the New York Stock Exchange for aiding and abetting Cowley's fraud and conversion, because those claims belonged to Cowley's customers, not to its estate. Moreover, the trustee could not assert those claims even though the customers assigned them to the trustee after Cowley's bankruptcy proceeding commenced, because then-existing federal law did not give trustees that power. *Barnes* has nothing to say with regard to whether the assignment would otherwise have been impermissible under state law.

In the instant case, the question before us is not whether TCW owns the claims (a matter of state law), but whether BSI can assert those claims as a result of a post-bankruptcy assignment from TCW. To the extent that the parties read *Barnes* as prohibiting the assignment in question, then, it is with regard to the decision's interpretation of a trustee's powers under *federal* law. Thus, *Barnes* does not bind us.

We are sympathetic to the parties' confusion on this point; this Court has not always clearly articulated the weight we have accorded various aspects of *Barnes*. However, notwithstanding Appellees' contention to the contrary, we have never adopted *Bar-*

nes' interpretation of the powers of the bankruptcy trustee under federal law as the law of this Circuit.

The three decisions that Appellees cite in support of their contention are *Bennett*, 336 F.3d at 102, *Wight*, 219 F.3d at 86, and *Mediators*, 105 F.3d at 826. Not one of these cases involves an assignment of claims from a debtor's creditor to a bankruptcy trustee (or equivalent), and thus none of them can be said to "follow" the rule of Barnes at issue in this case. Moreover, in each of those opinions, the context in which *Barnes* is cited makes clear that this Court was not even reaffirming the relevant rule of *Barnes* in dicta. In *Bennett*, 336 F.3d at 102, and *Wight*, 219 F.3d at 86, *Barnes* is mentioned only as the original citation for language the opinions quote from *Wagoner*,[10] and *Wagoner* specifically leaves open the

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[10] In Bennett, the court writes:

> Put another way, '[a] claim against a third party for defrauding a corporation with the cooperation of management, accrues to creditors, not to the guilty corporation.' *Wagoner*, 944 F.2d at 120. As the Court noted, 'even when defrauded creditors assigned to the trustee their claims against another for aiding and abetting the fraud the trustee lacked capacity to sue.' Id. at 118 (citing *Barnes* v. *Schatzkin*, 215 A.D. [at 13, 212 N.Y.S. 536]).
>
> In short, we hold that the defrauded investors and not the bankruptcy trustee are entitled to pursue the claims arising from the fraud.

336 F.3d at 102 (alterations in original). Thus, even though the *Bennett* Court quotes *Wagoner's* recitation of the relevant language from *Barnes*, it is only in the context of highlighting Wagoner's rule of imputation.

In *Wight*, the Court does not refer to the relevant language from *Barnes*: "In [*Wagoner*], we ruled that under governing New York law, '[a] claim against a third party for defrauding a corporation with the cooperation of management accrues to

question of when a bankruptcy trustee can assert claims on behalf of a debtor's creditors: "The trustee insists he is not asserting the claims of the noteholders, so it is unnecessary for us to delve deeply into when, if ever, a trustee may sue a third party on behalf of the bankrupt's creditors." 944 F.2d at 118. Similarly, in *Mediators*, the context in which *Barnes* is cited makes it clear that the court was not considering the application of *Barnes* to assigned claims: "A bankruptcy trustee has no standing *generally* to sue third parties on behalf of the estate's creditors * * *. Were the law otherwise, the debtor's assets would be depleted to enforce rights possessed by third parties, see [*Barnes*], and defendants would face the danger of duplicative recoveries." 105 F.3d at 826 (internal citations and quotation marks omitted) (emphasis added). Therefore, our cases do not support Appellees' claim that we have adopted the federal law aspect of *Barnes*.

B.

Having concluded that *Barnes* is not binding on us, we must now determine whether we find its reasoning persuasive. We do not; its rationale has been undermined by the inclusion of § 541(a)(7) in the current Bankruptcy Code. See 11 U.S.C. § 541(a)(7). Indeed, the significance of § 541(a)(7) was recognized in *Semi-Tech*—by the same court that decided *Barnes*. *Semi-Tech*, 13 A.D.3d at 187, 787 N.Y.S.2d 234; see also *Steinberg* v. *Kendig* (*In re Ben Franklin Retail Stores, Inc.*), 225 B.R. 646, 650 (Bankr. N.D. Ill.

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creditors, not to the guilty corporation.'" 219 F.3d at 86 (quoting *Wagoner*, 944 F.2d at 120 (citing *Barnes*)).

1998) ("Even if the New York court's majority opinion were otherwise persuasive, the inclusion of § 541(a)(7) in the current bankruptcy code effectively overrules *Barnes*."). Thus, we now hold that federal bankruptcy law permits BSI to press the TCW claims against E & Y.

The plaintiff in *Semi-Tech* was an entity ("LLC") created pursuant to a plan of liquidation to bring actions on behalf of a bankrupt estate ("Semi-Tech"). The plan provided for the assignment of "Creditor Causes of Action"—certain claims held by creditors ("Noteholders") of Semi-Tech against third-parties—to LLC as part of a settlement between Semi-Tech and the Noteholders. After the plan was approved by the bankruptcy court, many Noteholders opted into the plan's settlement and assigned their claims to LLC. In *Semi-Tech*, LLC asserted a number of these assigned claims against Ernst & Young LLP and several of its affiliates. The complaint alleged that the Canadian office of Ernst & Young, which served as Semi-Tech's pre-bankruptcy auditor, injured Noteholders by failing to report a number of Semi-Tech's questionable transactions.

As Appellees do here, the defendants in *Semi-Tech* asserted that LLC did not have standing to assert the assigned claims of the debtor's creditors against Ernst & Young under *Barnes*. The New York State Supreme Court disagreed:

> [T]he majority in *Barnes* based its reasoning on the Bankruptcy Law then in effect that had no provision permitting a trustee [to receive] property for the benefit of the estate * * *. Section 541(a)(7) in the current Bankruptcy Code clearly includes as property of the estate: "[a]ny interest in property that

> the estate acquires after the commencement of the case."

Semi-Tech Litigation, LLC v. *Ting*, Index No. 604644/2002, at 14 (N.Y. Gen. Term IAS Part 3 Mar. 24, 2004). The court concluded that, "given the current reading of the Bankruptcy Code, it is questionable whether *Barnes* remains good law" and held that LLC had standing to assert Semi-Tech's creditors' claims against Semi-Tech's auditor, Ernst & Young. *Id.*

The Appellate Division affirmed the Supreme Court's decision in relevant part. *Semi-Tech*, 13 A.D.3d at 187, 787 N.Y.S.2d 234. The court noted that its earlier "decision in [*Barnes*], which was decided before [the 1978] revisions to the bankruptcy laws and which, in distinction to the present case involving an assignment by the Bankruptcy Court to a specially created entity, involved assignments by the individual creditors to the trustee, does not compel a different result." *Id.* (internal citations omitted).

Appellees acknowledge that if *Semi-Tech's* view is applied to this case, BSI would have standing to assert the TCW claims. They do not dispute that the facts of this case replicate the facts of *Semi-Tech* almost exactly. Instead, Appellees argue we should not follow the decision for two reasons: first, the legislative history of the revisions to the Bankruptcy Code makes clear that Congress did not intend for those revisions to abrogate *Barnes*; and, second, the First Department's decision in *Semi-Tech* conflicts with the Second Department's decision in *P & F Industries, Inc.* v. *Medallion Group, Inc.*, 102 A.D.2d 865, 476 N.Y.S.2d 928 (2d Dep't 1984). Neither of Appellees' arguments is persuasive.

First, Appellees point to the legislative history of the 1978 revisions to the Bankruptcy Code as evidence that Congress did not intend those revisions to abrogate Barnes. In the same round of revisions in which Congress adopted § 541(a)(7)—the new section of the Code cited by the *Semi-Tech* Court as the basis for abrogating *Barnes*—Congress considered but rejected a proposed § 544(c). Section 544(c) provided in relevant part:

> (1) The trustee may enforce any cause of action that a creditor [or] a class of creditors * * * has against any person, if—(A) the trustee could not recover against such person on such cause of action other than under this subsection; (B) recovery by the trustee for the benefit of such creditor * * * or the members of such class will reduce the claim or interest of such creditor or * * * [creditors] * * * against or in the estate; (C) there is a reasonable likelihood that recovery against such person will not create an allowable claim in favor of such person against the estate; and (D) enforcement of such cause of action is in the best interest of the estate.

Mixon v. *Anderson* (*In re Ozark Rest. Equip. Co.*), 816 F.2d 1222, 1228 n.9 (8th Cir. 1987) (quoting H.R. 8200, 95th Cong., 1st Sess. 416-17 (1977)). Appellees argue that Congress could not have intended § 541(a)(7) to implicitly confer standing on bankruptcy trustees to assert the claims of a bankrupt's creditors, when, at the same time, it rejected a provision which would have explicitly conferred such standing. See also *id.* at 1228 ("[B]ecause Congress refused to enact subsection (c), we believe Congress' message is clear—*no* trustee * * * has power under Section 544

of the Code to assert general causes of action * * * on behalf of the bankrupt estate's creditors.").

In reality, the rejected § 544(c) would have significantly broadened the trustee's power to assert creditors' claims when compared to the Appellate Division's interpretation of § 541(a)(7) in *Semi-Tech*. Most importantly, it would have allowed a trustee to assert the claims of creditors without their assignment or permission. In explaining the import of the proposed § 544(c), the House Report stated:

> Subsection (c) is new. It overrules *Caplin* v. *Marine Midland Grace Trust Co.*, 406 U.S. 416 (1972), which precluded a * * * trustee from enforcing a claim on behalf of debenture holders against an indenture trustee for misconduct. The trustee is permitted to act as a class representative under this provision [under certain conditions] * * *. A judgment in the action binds all creditors * * * that could have brought the action, and the court may stay the commencement or continuation of any other action on the same cause of action. All creditors that could have brought the action are given notice of the trustee's suit, and nothing precludes such creditors from retaining their own attorneys and joining the action in their own behalf.

H.R. Rep. 95-595, 95th Cong., 1st Sess. 370-71 (1977), 1978 U.S.C.C.A.N. 5787, 6326, 6327. We can think of many arguments against allowing a trustee to usurp the claims of a bankrupt's non-cooperating creditors that do not counsel against permitting creditors to voluntarily transfer their claims to a trustee as part of a court-approved plan of reorganization or liquidation. There is no evidence to suggest

the grounds on which proposed § 544(c) was actually rejected.[11] Because it is perfectly plausible that Congress intended to leave *Caplin* intact without expressing any view on *Barnes*, we disagree with Appellees that Congress's rejection of § 544(c) fatally undermines the reasoning of *Semi-Tech*.

Second, Appellees argue that "the First Department's decision in *Semi-Tech* carries only modest weight as a predictor of New York law because it conflicts with the Second Department's decision in *P & F*." As we have already noted, however, Appellees point to no state law bar to the assignment of the TCW claims to BSI. Thus, to the extent that Appellees ask us to interpret federal law to bar such an assignment, a conflict between New York courts on the issue, while potentially informative, is not determinative.

In any event, Appellees misread *P & F*, which did not involve an assignment of claims from a debtor's creditor to a bankruptcy trustee. In *P & F*, a bankruptcy trustee unsuccessfully asserted claims against three defendants for fraudulently disguising a loan to the bankrupt as secured debt in order to give themselves an unfair advantage over the bankrupt's general creditors in bankruptcy proceedings. *P & F*, 102 A.D.2d at 866, 476 N.Y.S.2d 928. One of the bankrupt's creditors, P & F, sued the same three defendants for tortious interference with its contract

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[11] The only mention of § 544(c)'s rejection is contained in a joint explanatory statement between the House of Representatives and the Senate regarding provisions of the Code that were amended in the process of creating a compromise bill between the houses of Congress: "The House amendment deletes section 544(c) of the House bill." 124 Cong. Rec. 11,097 (Sept. 28, 1978).

with the bankrupt. *Id.* The defendants moved for summary judgment against P & F on the grounds that the trustee had already unsuccessfully litigated the same claim. *Id.* The Second Department reversed the trial court and denied the defendants' motion even though they agreed that P & F's tortious interference claim was premised on largely the same conduct as the bankruptcy trustees' fraud claim. See *id.* The court explained:

> The fact that the trustee in bankruptcy unsuccessfully litigated the issue of whether the 1976 loan transactions * * * were fraudulent as to [bankrupt's] general creditors does not preclude plaintiff from asserting that defendants tortiously interfered with its contract with [the bankrupt]. This claim was personal to plaintiff. It was not an asset of [the bankrupt's] before it was bankrupt or of its estate while it was in bankruptcy. It therefore could not have been asserted by the trustee in bankruptcy.

Id. at 866-67, 476 N.Y.S.2d 928 (internal citations omitted). Thus, *P & F* held that a bankruptcy trustee cannot assert the non-assigned claims of a bankrupt's individual creditors, because such claims are not part of the bankrupt's estate. That holding does not conflict with *Semi-Tech's* holding that a trustee may assert claims assigned to it by a bankrupt's creditors for the benefit of the estate, because those claims can become property of the estate under § 541(a)(7).

Allowing a debtor's creditors to assign their claims for the benefit of the debtor's estate permits debtors, creditors, and bankruptcy courts the flexibility in reorganizing or liquidating a debtor's assets

necessary to achieve efficient administration of the reorganization or liquidation. Indeed, the voluntary and court-approved assignment at issue in this case perfectly illustrates how both a debtor and its creditors can benefit from the flexibility that § 541(a)(7) of the Bankruptcy Code facilitates. The *Barnes* view would unnecessarily hamstring those parties on the basis of an outdated version of the Bankruptcy Code. Because neither of Appellees' arguments convinces us otherwise, we hold that BSI has standing to assert the TCW claims against E & Y.

III.

Because we have found that BSI has standing to assert both the CBI and the TCW claims against E & Y, we must reach the two arguments that Appellees press on cross-appeal. We first answer the question: Are the CBI and TCW claims "core proceedings" that may be tried by a bankruptcy judge?

The distinction between "core" and "related" matters in the context of bankruptcy (or "title 11") proceedings can be traced back to *Northern Pipeline Construction Co.* v. *Marathon Pipe Line Co.*, 458 U.S. 50 (1982), and is now codified at 28 U.S.C. § 157(b). In *Marathon*, the plurality opinion held that a non-Article III bankruptcy judge could not adjudicate a pre-petition contract dispute arising under state law against a party that had not filed a proof of claim and was not otherwise related to the bankruptcy proceedings. The plurality explained that "Article III bars Congress from establishing legislative courts to exercise jurisdiction over all matters related to those arising under the bankruptcy laws," 458 U.S. at 75, and it distinguished between "the restructuring of debtor-creditor relations, which is at the core of the federal bankruptcy power," and "the

adjudication of state-created private rights, such as the power to recover contract damages," *id.* at 71. In response to the Court's decision, Congress enacted 28 U.S.C. § 157, authorizing district courts to refer "any or all cases under title 11 and any or all proceedings arising under title 11 or arising in or related to a case under title 11" to bankruptcy judges under subsection (a), and defining the reach of the bankruptcy court's power under subsections (b) and (c). See *Arnold Print Works, Inc.* v. *Apkin* (*In re Arnold Print Works, Inc.*), 815 F.2d 165, 166-67 (1st Cir. 1987) (Breyer, J.) (describing the history of 28 U.S.C. § 157). Subsection (b) provides that bankruptcy judges may "hear and determine all cases under title 11 and all *core* proceedings arising under title 11, or arising in a case under title 11." 28 U.S.C. § 157(b)(1) (emphasis added). Subsection (c) provides that bankruptcy judges "may hear a proceeding that is not a core proceeding but that is otherwise *related* to a case under title 11," but may only "submit proposed findings of fact and conclusions of law to the district court" on such matters. *Id.* § 157(c)(1) (emphasis added). In such a case, "any final order or judgment shall be entered by the district judge after considering the bankruptcy judge's proposed findings and conclusions and after reviewing de novo those matters to which any party has timely and specifically objected." *Id.* But see *Orion Pictures Corp.* v. *Showtime Networks, Inc.* (*In re Orion Pictures Corp.*), 4 F.3d 1095, 1101 (2d Cir. 1993) (holding that "[r]elated" proceedings in which the parties are entitled to a jury trial must be tried in district court).

A bankruptcy court's power to "enter appropriate orders and judgments" in a given bankruptcy proceeding therefore hinges on whether the proceeding is "core" or "related," see 28 U.S.C. §§ 157(b)(1),

(c)(1), consistent with the constitutional limits that Marathon established. See *S.G. Phillips Constructors, Inc.* v. *City of Burlington* (*In re S.G. Phillips Constructors, Inc.*), 45 F.3d 702, 705 (2d Cir. 1995). Section 157 does not define "core proceeding." Instead, it contains a non-exhaustive list of core proceedings, 28 U.S.C. § 157(b)(2), relevantly including: matters affecting the "allowance or disallowance of claims against the estate," § 157(b)(2)(B); and "counterclaims by the estate against persons filing claims against the estate," § 157(b)(2)(C). Appellees dispute the district court's holding that all of the claims asserted by BSI are core proceedings as defined by § 157(b)(2)(B) and/or (C). Appellees contend, on the contrary, that both the CBI claims and the TCW claims are related proceedings that must be tried by a district court judge. We disagree. Because all of the claims asserted by BSI are covered by the language of 28 U.S.C. § 157(b) and are integrally related to the Proof of Claim that E & Y voluntarily submitted against the estate, they are core proceedings triable by a bankruptcy judge.

A.

In crafting § 157, "Congress realized that the bankruptcy court's jurisdictional reach was essential to the efficient administration of bankruptcy proceedings and intended that the 'core' jurisdiction would be construed as broadly as possible subject to the constitutional limits established in *Marathon*." *S.G. Phillips Constructors*, 45 F.3d at 705. Both this Court and the Supreme Court have honored that intention by "conclud[ing] that the *Marathon* holding was a narrow one and * * * [by] broadly construe[ing] the jurisdictional grant" to bankruptcy courts contained in § 157(b). *Id.*; see also *U.S. Lines, Inc.* v. *Am.*

S.S. Owners Mut. Prot. & Indem. Ass'n (*In re U.S. Lines, Inc.*), 197 F.3d 631, 637 (2d Cir. 1999) ("'[C]ore proceedings' should be given a broad interpretation that is 'close to or congruent with constitutional limits.'"). All of the CBI claims are explicitly core under the language of § 157(b), because they either affect the "allowance or disallowance of [a] claim[ ] against the estate,"28 U.S.C. § 157(b)(2)(B), are "counterclaims by the estate against persons filing claims against the estate," *id.* § 157(b)(2)(C), or both.

CBI's claim for expungement of E & Y's Proof of Claim is unquestionably a core proceeding; it directly affects the allowance of E & Y's claim against CBI's estate. See 28 U.S.C. § 157(b)(2)(B); *S.G. Phillips Constructors*, 45 F.3d at 705 ("Nothing is more directly at the core of bankruptcy administration * * * than the quantification of all liabilities of the debtor."); see also *Gulf States Exploration Co.* v. *Manville Forest Prods. Corp.* (*In re Manville Forest Prods. Corp.*), 896 F.2d 1384, 1389-90 (2d Cir. 1990). Similarly, insofar as CBI's claims for fraud (both as to performance of the audits and inducement to perform the re-audit), negligence and breach of contract are related to the "professional services rendered in 1993 and 1994 on behalf of [CBI] in connection with the audit of [CBI]'s financial statements and other special engagements" for which E & Y seeks compensation via its Proof of Claim, they too are core.[12]

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[12] It is not clear precisely to what extent BSI's fraud, negligence and breach of contract claims are direct defenses to E & Y's Proof of Claim, because—as noted by the district court—it is not clear what accounting services are covered by E & Y's fees claim. See *CBI II*, 311 B.R. at 362 n. 4. By its terms, the Proof of Claim covers services rendered in 1993 and 1994. If it does, then insofar as CBI's claims allege fraud, negligence and/or

"[M]alpractice is a defense to an action to recover for professional services" under New York law. *Altamore* v. *Friedman*, 193 A.D.2d 240, 247, 602 N.Y.S.2d 894 (2d Dep't 1993). Likewise, "if by misrepresentation * * *, the plaintiffs were induced to enter into the agreement in suit, * * * the defendant has * * * forfeited all right to compensation for services rendered." *Bowen* v. *Merdinger*, 196 Misc. 987, 991, 92 N.Y.S.2d 566 (N.Y. Sup. Ct. 1949). As defenses to E & Y's fees claim, these CBI claims also directly affect the allowance of that claim. "Proceedings can be core by virtue of their nature if * * * the proceedings directly affect a core bankruptcy function." *U.S. Lines*, 197 F.3d at 637 (citation omitted); *S.G. Phillips Constructors*, 45 F.3d at 705 (holding that proceedings that affect the allowance of a claim are core). All of these claims affect one of the most elemental of all core bankruptcy functions: determining if a creditor may collect from a debtor's estate.

We agree with the district court that because "CBI's remaining claims of negligence, breach of contract, and fraud are based upon the same operative facts as" the above core proceedings "and were filed in response to [E & Y's] Proof of Claim, which is based on the same set of facts, those claims are also * * * core." *CBI II*, 311 B.R. at 363. "A response to a

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breach of contract with regard to either the 1993 audit or the 1994 re-audit, the claims are direct defenses to E & Y's fees claim. However, the exhibits attached to E & Y's Proof of Claim, which purport to detail the services for which payment is owed, contain only invoices from 1994. If E & Y's fees claim only relates to the re-audit, then CBI's claims are only direct defenses insofar as they implicate the re-audit. However, we need not determine the precise scope of E & Y's fees claim, because all of the CBI claims are counterclaims to the fees claim and thus core proceedings under 28 U.S.C. § 157(b)(2)(C). See *infra*.

proof of claim which is, in essence, a counterclaim, is a core proceeding under 28 U.S.C. § 157(b)(2)(C)." *Bank of Lafayette* v. *Baudoin* (*In re Baudoin*), 981 F.2d 736, 741 (5th Cir. 1993) (holding that debtor's contract and tort claims regarding loans were "core" when creditor filed proof of claim based on same loans).

Appellees direct us to our decision in *Orion Pictures*, which they argue suggests that even where a claim arguably falls within the language of one of § 157(b)(2)'s broad provisions, it may still not be core within the limits of *Marathon*. See *Orion Pictures*, 4 F.3d at 1102 ("The problem * * * is that it creates an exception to *Marathon* that would swallow the rule. Any contract action that the debtor would pursue against a defendant presumably would be expected to inure to the benefit of the debtor estate and thus 'concern[s]' its 'administration'" under § 157(b)(2)(A). (alteration in original)).[13] However, even if not all claims that fall within the "core" categories designated by § 157(b)(2)(B) and (C) would fall within the constitutional limits that *Marathon* identified, CBI's claims are so factually and legally interconnected with E & Y's fees claim against the estate, as well as with CBI's primary defenses to that claim, that their

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[13] Appellees raise this claim specifically in response to the district court's holding that all of the CBI claims also fall under the "catch-all" provisions of 28 U.S.C. § 157(b)(2): (A) ("matters concerning the administration of the estate") and (O) ("other proceedings affecting the liquidation of the assets of the estate or the adjustment of the debtor-creditor or the equity security holder relationship, except personal injury tort or wrongful death claims"). We express no opinion on that holding. The two provisions under which we find the CBI claims to be core—§ 157(b)(2)(B) and (C)—are not as broadly worded.

designation as core does not breach those limits. See *U.S. Lines*, 197 F.3d at 637 (recognizing "the degree to which the proceeding is independent of [debtor's] reorganization" to be relevant to its core status post-*Marathon*); see also *Manville*, 896 F.2d at 1390 (holding that party who filed a proof of claim against the debtor was, unlike the defendant in *Marathon*, not "a third party related only peripherally to the adjudication of [the debtor's] estate" and "[t]he determination of the objection to and allowance of its claim is clearly within the traditional core jurisdiction of the bankruptcy court"); *Resolution Trust Corp.* v. *Best Prods. Co.* (*In re Best Prods. Co.*), 68 F.3d 26, 32 (2d Cir. 1995) ("Unlike a proceeding that simply seeks to augment the estate, the present proceeding involves the priority rights of creditors who have filed claims against the estate."). Moreover, "[w]e do not think that anything in *Marathon* alters the basic principle that the filing of a proof of claim invokes the special rules of bankruptcy * * *." *S.G. Phillips Constructors*, 45 F.3d at 706 (internal quotation marks omitted).

Appellees also contend that none of CBI's claims can be deemed core on the basis that they affect the allowance of E & Y's Proof of Claim, because as objections to that claim they would be time-barred under the Plan. The parties agree that the Plan set a "bar date" of December 1, 1995 for filing objections to creditors' claims and that the Creditors' Committee timely filed an objection to E & Y's Proof of Claim, which it later assigned to BSI. However, E & Y alleges that the initial objection filed by the Creditors' Committee only referenced the "excessive" amount of E & Y's claim, and argues that the Creditors' Committee could not amend that objection to assert new claims against E & Y after the bar date passed (*e.g.*, for malpractice).

E & Y offers no authority for its contention that once an objection to a proof of claim is made, it can never be amended after the bar date.[14] Nor do Appellees explain why a claim must be "an objection" to a creditor's claim against an estate in order to qualify as a core proceeding affecting the allowance of such a claim under 28 U.S.C. § 157(b)(2)(B). However, even if we accepted Appellees' argument *arguendo*, it would not affect our holding that all of the CBI claims are core. The Plan's bar date did not apply to counterclaims filed in an adversary proceeding. All of the CBI claims are interconnected with E & Y's fees claim. Thus, all of the CBI claims are counterclaims against E & Y and core pursuant to § 157(b)(2)(C). See *Baudoin*, 981 F.2d at 741.

Appellees also argue that the CBI claims cannot be deemed core, because CBI's $45 million in claims arise under state law, would exist even if CBI had not gone bankrupt, and are disproportionate to E & Y's $210,850 fees claim. Appellees derive the rule on which they base this argument—that, "counterclaims based on state law causes of action that would exist independently of a bankruptcy and are disproportionate to the proof of claim can never be treated as core"—from two cases: *Complete Management* v. *Arthur Andersen, LLP* (*In re Complete Management, Inc.*), 02-CIV-1736, 2002 WL 31163878 (S.D.N.Y. Sept. 27, 2002) and *Marshall* v. *Marshall* (*In re Marshall*), 264 B.R. 609 (C.D. Cal. 2001). Neither binds

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[14] Indeed, the only authority Appellees purport to cite for their contention, 9 Collier on Bankruptcy ¶ 3001.04[1] (15th ed. 2005), refers solely to post-bar date amendments to *proofs of claim*—as opposed to *objections* thereto—in the referenced language.

us. Moreover, neither actually stands for Appellant's rule, which we decline to adopt.

In *Complete Management*, the debtor's auditor, Arthur Andersen, asserted a proof of claim against the debtor in bankruptcy court for professional services rendered. 2002 WL 31163878, at *1. In response, debtor filed an adversary proceeding in bankruptcy court against Arthur Andersen alleging malpractice, and Arthur Andersen moved in district court to withdraw the proceeding from bankruptcy court under 28 U.S.C. § 157(d). *Id.* That provision permits a district court to "withdraw, in whole or in part, any case or proceeding referred under this section, on its own motion or on timely motion of any party, for cause shown." 28 U.S.C. § 157(d). In deciding whether to grant the motion to withdraw, the district court considered a number of factors, including whether the malpractice claim was "core" (which, if it were, would weigh against withdrawal). *Complete Mgmt.*, 2002 WL 31163878, at *2. Appellees claim that "the court held that core status does not 'extend[ ] to a counterclaim that is, as here, seventy times greater than the proof of claim.'"[15] That is, however, a mischaracterization of *Complete Management's* holding. To be sure, the district court in *Complete Management* did seem to think that the size of the debtor's counterclaim distinguished that

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[15] Another difference between *Complete Management* and the instant case is that the plaintiffs in *Complete Management* argued principally that their claims were core under 28 U.S.C. § 157(b)(2)(O) ("other proceedings affecting the liquidation of the assets of the estate or the adjustment of the debtor-creditor or the equity security holder relationship, except personal injury tort or wrongful death claims").

case from others.[16] 2002 WL 31163878, at *3. However, the court did not hold that the counterclaim was non-core on that basis alone, but explained that even if the counterclaim was "technically a core proceeding," other factors weighed in favor of *discretionary* withdrawal. *Id.* Ultimately, even under a reading of *Complete Management* favorable to Appellees, the case does not create a rule that the sort of counterclaim at issue in this case can never be core.

Marshall involves a proof of claim and an adversary proceeding filed by Pierce Marshall in the bankruptcy of his step-mother, Vickie Lynn Marshall (aka Anna Nicole Smith). *Marshall*, 264 B.R. at 616. Pierce alleged that Vickie defamed him when some of her lawyers told members of the press that he used forgery, fraud and overreaching to gain control of his father's assets. *Id.* Vickie counterclaimed, alleging that Pierce tortiously interfered with her expectation of an *inter vivos* gift from her since-deceased husband. *Id.* at 617. The bankruptcy court found that

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[16] Indeed, the quotation from which Appellees excerpt *Complete Management's* holding reads, in full:

> There is some case law support for [debtor's] position that, since Andersen filed a proof of claim against the estate of [debtor] in the Bankruptcy Court, the adversary proceeding by [debtor] against Andersen for negligence in performing its audit work for [debtor] is a counterclaim, and therefore a core proceeding. However, while the cases speak of the filing of a proof of claim subjecting the claimant to the equitable jurisdiction of the Bankruptcy Court, no case has suggested that the equitable jurisdiction extends to a counterclaim that is, as here, seventy times greater than the proof of claim.

2002 WL 31163878, at *3 (internal footnote omitted).

Vickie's counterclaim was core and Pierce disputed that finding on appeal. *Id.* at 625. While it is true, as Appellees argue, that the district court noted that Vickie's claim "dwarf[ed] Pierce's defamation [claim] in all respects, both in terms of the time and effort spent litigating it and the size of the potential judgment," the court's reversal of the bankruptcy court rested on a number of factors—particularly, the "attenuated" nexus between the transactions out of which Pierce's claim and Vickie's counterclaim arose, and the "entirely different" issues of law raised by the two claims. *Id.* at 631-32. Because *Marshall's* holding rested on "the unique characteristics and context of [Vickie's] counterclaim," it cannot be read as standing for the general rule that the sort of counterclaim at issue in this case can never be core. *Id.* at 632. Moreover, because CBI's claims against E & Y unquestionably share a common transactional nexus with, and raise similar issues of law to, E & Y's Proof of Claim, *Marshall's* context-specific holding is inapposite here.[17]

B.

The TCW claims are in a slightly different posture than the CBI claims; none of them affect the allowance of E & Y's fees claim against the estate. Nonetheless, the TCW claims qualify as core under the language of § 157(b)(2)(C), because they are "counterclaims by the estate against persons filing claims against the estate." After *Marathon*," [p]roceedings can be core by virtue of their nature if * * * the type of proceeding is * * * uniquely affected

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[17] Whether Vickie's counterclaim is core is still an open question before the Ninth Circuit. See *Marshall* v. *Marshall*, 547 U.S. 293, 315 (2006).

by the bankruptcy proceedings." *U.S. Lines*, 197 F.3d at 637. Here, the TCW claims are related to and arise out of the same transaction as E & Y's fees claim, and a determination on the TCW claims would likely be dispositive of E & Y's claim. Similarly, a decision by the bankruptcy court on E & Y's claim or the CBI claims would resolve many of the factual and legal issues involved in the TCW claims, including the central issue: Whether E & Y committed fraud, or was reckless and/or negligent, in connection with its audits of CBI. Thus, we have no trouble concluding that the TCW claims are core.

Appellees argue that the TCW claims should not be deemed core as a matter of policy. They warn of the "perils of affording core status to claims asserted on behalf of persons or entities other than the debtor." Specifically, Appellees point to the risk of "jurisdiction by assignment" in violation of 28 U.S.C. § 1359,[18] whereby "third-party litigation could routinely be transformed into a core bankruptcy proceeding simply by assigning the claim to the estate."[19] Appellees' policy concern might be valid in

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[18] Section 1359 provides that: "A district court shall not have jurisdiction of a civil action in which any party, by assignment or otherwise, has been improperly or collusively made or joined to invoke the jurisdiction of such court."

[19] Appellees also cite to *131 Liquidating Corp.* v. *LaSalle Capital Group, Inc.* (*In re 131 Liquidating Corp.*), 222 B.R. 209 (S.D.N.Y. 1998) in support of their argument. E & Y asserts that the case stands for the proposition that the fact that a claim arises out of the same transaction as core claims does not necessarily "render[ ] the claim core." Whether or not that is an accurate reading of *131 Liquidating*, the case does not resemble the factual context of this case. See 222 B.R. at 212. In *131 Liquidating*, the district court found that a claim brought by the debtor and its shareholders against three individual principals

theory, but there is no evidence that the assignment in this case was made for the purpose of manufacturing the bankruptcy court's jurisdiction. Indeed, as the district court noted, the assignment here "was effected as an integral part of the Plan, which was approved by the bankruptcy court." *CBI II*, 311 B.R. at 364.

Thus, we hold that the bankruptcy court had jurisdiction to try both the CBI claims and the TCW claims, because they are both core proceedings.

IV.

That leaves the last line of defense raised in Appellees' cross-appeal: Were Appellees' Seventh Amendment rights violated when they were not afforded a jury trial on the CBI claims?

The Seventh Amendment protects the right to a jury trial only for matters at law, "in contradistinction" to those in equity. *Granfinanciera, S.A.* v. *Nordberg*, 492 U.S. 33, 41 (1989); see also U.S. Const. amend. VII ("In Suits at common law, where the value in controversy shall exceed twenty dollars, the right of trial by jury shall be preserved * * *."). In evaluating whether E & Y had a jury trial right to

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of one of the debtor's creditors was not core. *Id.* at 211. However, those principals had not filed a proof of claim against the estate, nor (according to the district court) did the claims against them qualify as core under any of the express provisions of § 157(b)(2). *Id.* at 211-12. In this case, the TCW claims are core under the language of § 157(b)(2)(C). That conclusion does not contravene the limits of *Marathon* because TCW's claims are integrally related to the core bankruptcy proceedings. We express no judgment on the question of when, if ever, a claim that does not qualify as core under § 157(b)(2)'s express language could be rendered core only on the grounds that it is based on the same transaction as a core proceeding.

adjudication of CBI's claims, "[w]e are required to analyze the underlying nature of the claim without regard to Congress' designation of that claim as core." *Ben Cooper, Inc.* v. *Ins. Co. of the State of Pa. (In re Ben Cooper, Inc.)*, 896 F.2d 1394, 1401 (2d Cir. 1990), *vacated and remanded on other grounds*, 498 U.S. 964 (1990), *reinstated at* 24 F.2d 36 (2d Cir. 1991). Generally, our inquiry under *Granfinanciera* proceeds in two steps. "First, we ask whether the action would have been deemed legal or equitable in 18th century England. Second, we examine the remedy sought and determine whether it is legal or equitable in nature." *Pereira* v. *Farace*, 413 F.3d 330, 337 (2d Cir. 2005) (internal quotation marks and citations omitted).

There is no question that, outside of the bankruptcy context, CBI's first through fifth claims,[20] and all of the TCW claims, are legal in nature. Appellees also do not appeal from the district court's decision that E & Y is entitled to a jury trial with regard to the TCW claims. However, *Granfinanciera* and *Langenkamp* v. *Culp*, 498 U.S. 42 (1990) (per curiam), also recognized that "by filing a claim against a bankruptcy estate the creditor triggers the process of 'allowance and disallowance of claim,' thereby subjecting himself to the bankruptcy court's equitable power." *Langenkamp*, 498 U.S. at 44, 111 S. Ct. 330 (construing *Granfinanciera*, 492 U.S. at 58-59). If the bankruptcy trustee responds by filing its own claim against the creditor that would eliminate the basis for the creditor's claim, those two claims "become integral to the restructuring of the debtor-creditor re-

[20] The only claim that sounds solely in equity is CBI's claim for the expungement of E & Y's Proof of Claim.

lationship through the bankruptcy court's equity jurisdiction. As such, there is no Seventh Amendment right to jury trial." *Id.* at 44-45. Thus, the question in this case is whether, by filing its proof of claim against the debtor, Appellees submitted themselves to the jurisdiction of the bankruptcy court for CBI's claims asserted in response to that claim because resolution of those claims became integral to restructuring the debtor-creditor relationship. We hold that it did. Appellees contend that, in the alternative, their "conceded entitlement to a jury trial on the TCW claims requires that the CBI portion of the judgment be vacated" under the rule of *Lytle* v. *Household Manufacturing Inc.*, 494 U.S. 545 (1990). Because Supreme Court case law instructs that *Lytle* does not apply in the context of bankruptcy, we disagree. See *Katchen* v. *Landy*, 382 U.S. at 323.

A.

Filing a proof of claim against a bankruptcy estate triggers the process of "allowance and disallowance of claims," and, therefore, a creditor who files such a claim subjects itself to the bankruptcy court's equitable jurisdiction in proceedings affecting that claim. *Granfinanciera*, 492 U.S. at 58. In *Langenkamp*, the Supreme Court held that if a creditor who has filed such a claim is met with an adversary proceeding, the resolution of which affects the equitable restructuring of debtor-creditor or creditor-creditor relations, then the creditor loses its right to a jury trial even with regard to traditional legal claims. See 498 U.S. at 44; *Granfinanciera*, 492 U.S. at 58-59 & n.14. As we recognized in *Germain* v. *National Bank*, 988 F.2d 1323 (2d Cir. 1993), filing a proof of claim is a necessary but not sufficient condition to forfeiting a creditor's right to a jury trial. See *id.* at 1327.

Rather, a creditor loses its jury trial right only with respect to claims whose resolution affects the allowance or disallowance of the creditor's proof of claim or is otherwise so integral to restructuring the debtor-creditor relationship. *Id.* That E & Y waived its right to a jury trial with regard to the CBI claims by filing its Proof of Claim follows directly from this decision: E & Y filed a proof of claim against CBI; the CBI claims were asserted in response to that proof of claim; and, insofar as we have already held that the CBI claims are either defenses to E & Y's fees claim or integrally related to those defenses, the resolution of the CBI claims clearly affects the structuring of the debtor-creditor relationship between CBI and E & Y.

Notwithstanding *Langenkamp*, Appellees contend that under this Court's decision in *Germain*, a creditor does not lose its jury trial rights as to debtor-asserted counterclaims based on "actions that are neither in violation of nor in compliance with the Bankruptcy Code, but are independent of and outside the reach of the bankruptcy process." *Germain*, 988 F.2d at 1328. In *Germain*, a creditor filed a proof of claim against the debtor in a bankruptcy proceeding. *Id.* at 1325. Six months later, the debtor commenced a suit in state court against the creditor, and the creditor subsequently removed the action to bankruptcy court. *Id.* The debtor's suit claimed that the creditor had used its power as the debtor's primary lender to exercise control of the debtor to its detriment and alleged that this conduct constituted tortious interference with the debtor's business, coercion and duress, breach of good faith, unfair business practices, and misrepresentation. *Id.* at 1326. The *Germain* Court characterized the action at issue as "'quintessentially [a] suit[ ] at common law that more

nearly resemble[s] state-law contract [and tort] claims brought by a bankrupt corporation to augment the bankruptcy estate than [it does] creditors' hierarchically ordered claims to a pro rata share of the bankruptcy res,'" and, on that basis, found that the debtor was entitled to a jury trial because the debtor's claims retained their "legal" nature. *Id.* at 1328 (quoting *Granfinanciera*, 492 U.S. at 56) (alterations in original). Thus, Appellees argue that because the *Germain* Court's characterization of the debtor's claims also applies to CBI's claims, E & Y is entitled to a jury trial under *Germain*.

Appellees' argument is unpersuasive because the relationship between the creditor's and debtor's claims in *Germain* is materially different than that between CBI's and E & Y's claims here. In particular, the debtor's claims in *Germain* were not asserted to counter the proof of claim that the creditor filed in its bankruptcy proceedings. *Id.* at 1325. Indeed, the debtor in *Germain* did not object to the creditor's proof of claim, which was based entirely on pre-bankruptcy business dealings between the debtor and creditor. *Id.* Rather, the debtor commenced independent litigation in state court six months later solely directed at the creditor's conduct after the debtor filed for bankruptcy. *Id.* The only reason the debtor's claims ended up in bankruptcy court was because the creditor removed them from state court. *Id.* Thus, resolution of the debtor's claims in *Germain* would not affect the equitable restructuring of the debtor-creditor relationship in debtor's bankruptcy proceeding. By contrast, here, the CBI claims were asserted in the bankruptcy proceedings to counter E & Y's Proof of Claim, and their resolution would directly affect the bankruptcy court's equitable restructuring of the debtor-creditor relationship. Indeed, the

Germain Court explicitly distinguished this type of a situation—where the action in which a jury trial is sought is actually part of the claims-allowance process:

> A different result might adhere if the action had become part of the claims-allowance process * * *. An action that bears directly on the allowance of a claim is integrally related to the equitable reordering of debtor-creditor and creditor-creditor relations. If an equitable reordering cannot be accomplished without resolution of what would otherwise be a legal dispute, then that dispute becomes an essential element of the broader equitable controversy.

Id. at 1329 (internal citation omitted). Therefore, *Germain* does not alter the well-established principle that Appellees are not entitled to a jury trial on the CBI claims that are integral to, and directly affect the allowance of, the proof of claim they filed with the bankruptcy court.

B.

Lastly, Appellees contend that even if this Court finds that E & Y is not entitled to a jury trial on the CBI claims, E & Y is still entitled to vacatur of the portions of the bankruptcy court's judgment that relate to the CBI claims under *Lytle*. See 494 U.S. at 550-52. In *Lytle*, the Supreme Court held that when a trial court erroneously dismisses the legal—and therefore jury-triable—claims in a case involving legal and equitable claims with common issues of fact, and then goes on to rule on the remaining equitable claims, the court's judgment must be vacated in full because the parties are entitled to have a jury decide

the claims' common issues of fact under the Seventh Amendment. *Id.* at 555, 556 n.4. Appellees contend that the basic principle on which *Lytle* is based—that parties are entitled to have factual issues in legal claims resolved by a jury in the first instance—is applicable here. Appellees point to the issues of fact common to the CBI and TCW claims that were resolved by the bankruptcy court's judgment (*e.g.*, whether E & Y is guilty of fraud, recklessness and/or negligence), and argue that because it is now undisputed that E & Y is entitled to a jury trial on the TCW claims, it is also entitled to Lytle's remedy of vacatur.[21]

Both parties agree that if *Lytle* applies to this case, it would require vacatur of the bankruptcy court's judgment. However, under the Supreme Court's decision in *Katchen*, the *Lytle* rule does not apply in the context of bankruptcy proceedings. See *Katchen*, 382 U.S. at 338-39. In *Katchen*, the Supreme Court held that it was permissible for a bankruptcy court to hold a bench trial on an equitable claim, even if its judgment would have res judicata effect on factual issues common to a jury triable legal claim, without violating the Seventh Amendment. *Id.* *Katchen* thus rejects the *Lytle* principle that parties are entitled to have the factual issues underlying their legal claims heard by juries in the first instance, and its correlative remedy of stay or vacatur, in the bankruptcy context.[22] Therefore, not only is E

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[21] As previously noted, the district court's holding that E & Y is entitled to vacatur of the portions of the judgment that relate only to the TCW claims is not at issue in this appeal.

[22] A federal court, or a state court for that matter, cannot ordinarily preempt a defendant's Seventh Amendment rights by deciding factual issues on equitable claims that are common to le-

& Y not entitled to vacatur of the portions of the bankruptcy court's judgment that relate to the CBI claims, but to the degree that the court's judgment on those claims is dispositive of factual issues underlying the TCW claims, E & Y may also be collaterally estopped from relitigating those issues at its jury trial on the TCW claims.[23]

Appellees do not dispute that if *Katchen* applies here, E & Y is not entitled to vacatur under *Lytle*. Instead, Appellees allege that *Katchen* is no longer good law, because it "is an artifact of the archaic scheme of the Bankruptcy Act of 1898, in which certain claims could not be tried in federal court, but instead [had] to be tried via a separate 'plenary' suit in state court (absent a non-bankruptcy basis for federal jurisdiction)." Appellees explain that "[i]t was against this background of delay and expense resulting from having to wait for trial of the plenary action in a separate tribunal that the *Katchen* Court concluded that the equitable proceedings * * * could go first." Appellees argue that because the Bankruptcy Code of 1978 eliminated this need for delay by giving federal courts jurisdiction over all claims arising in the context of bankruptcy proceedings, the *Katchen* rationale for abrogating *Lytle* in the context of bankruptcy has been eliminated.

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gal claims while reserving those legal claims for a later jury trial. That would indeed constitute a right with no real remedy. However, when one steps into Bankruptcy Court, one knows the rules of engagement on a proof of claim and the defenses thereto. They do not include a right to a jury trial.

[23] The preclusive effect of the bankruptcy court's judgment depends on other legal considerations, which we need not explore here.

Appellees' reasoning might very well be sound, but to no avail. This Court does not have the discretion to ignore Supreme Court precedent simply because the reasoning on which it is premised may seem no longer viable. The Supreme Court has explicitly stated that if its precedent "has direct application in a case, yet appears to rest on reasons rejected in some other line of decisions, the Court of Appeals should follow the case which directly controls, leaving to [the Supreme] Court the prerogative of overruling its own decisions." *Rodriguez de Quijas* v. *Shearson/Am. Express, Inc.*, 490 U.S. 477, 484 (1989); see also *Bach* v. *Pataki*, 408 F.3d 75, 86 (2d Cir. 2005). Moreover, *Katchen's* relevant holding has been repeatedly reaffirmed after the Bankruptcy Code of 1978's enactment by both the Supreme Court, see, *e.g.*, *Parklane Hosiery Co.* v. *Shore*, 439 U.S. 322, 334-35 (1979), and this Court, see, *e.g.*, *Agudas Chasidei Chabad* v. *Gourary*, 833 F.2d 431, 438 (2d Cir. 1987). Thus, at least until the Supreme Court holds otherwise, *Katchen* is still good law and Appellees are not entitled to relief under *Lytle*. Therefore, the portions of the bankruptcy court's judgment related to the CBI claims need not be vacated.

CONCLUSION

We reject both of Appellees' challenges to BSI's standing to assert the CBI and TCW claims. CBI management's role in defrauding the company's creditors is not a bar to BSI asserting the company's claims against its former accountant, because the bankruptcy court's finding that management had "totally abandoned" the company's interests was not clearly erroneous. The rights of a trustee to accept and protect property after the commencement of

bankruptcy proceedings is an issue of federal bankruptcy law; § 541(a)(7) of the Bankruptcy Code permits a trustee (or equivalent) to assert claims against a third party that were assigned to the trustee by a creditor of the bankrupt whose shoes it fills. Similarly, we reject both of the challenges that Appellees press to the venue and manner in which BSI chooses to assert its claims. The CBI and TCW claims are all core proceedings that may be tried in a bankruptcy court. The CBI claims may be tried without a jury and before any claims that require a jury trial.

For the foregoing reasons, the judgment of the district court is AFFIRMED in part, REVERSED in part, and REMANDED to the district court for proceedings in accordance with this decision.

APPENDIX B

[Opinion of the United States District Court For the Southern District of New York (October 25, 2004)]

United States District Court, Southern District of New York.

In re CBI HOLDING COMPANY, INC., et al., Debtors,

Ernst & Young and Ernst & Young, LLP, Appellants,

v.

Bankruptcy Services, Inc., Appellee.

Bankruptcy No. 94-B-43819 (BRL).

Adversary No. 01-CIV-0131 (KMW).

Oct. 25, 2004.

WOOD, U.S.D.J.:

On June 26, 2004, this Court issued an Opinion & Order (the "June Order") resolving some, but not all, of the issues on appeal. The Court concluded, *inter alia*, that Ernst & Young and Ernst & Young, LLP (collectively, "Ernst & Young") were entitled to a jury trial with respect to the claims brought by Bankruptcy Services, Inc. ("BSI") on behalf of Trust Company of the West ("TCW") in its role as a creditor of CBI Holding Company, Inc. ("CBI"). The Court ordered the parties to provide additional briefing on the question of whether the Court's conclusion that

Ernst & Young is entitled to a jury trial with respect to BSI's claims on behalf of TCW necessitates a new trial on BSI's claims on behalf of CBI as well. The Court indicated in the June Order that the resolution of that question would render moot some, if not all, of the outstanding issues on appeal.[1] The Court has received the parties' supplemental briefs on the jury trial question.

On July 8, 2004, Ernst & Young filed a motion for rehearing, in which Ernst & Young asked the Court to reconsider two of its earlier holdings, and to rule on several additional issues that the Court left unresolved in the June Order.[2] That motion became fully briefed on August 13, 2004. For the reasons stated below, the Court grants the motion for rehearing, vacates in full the judgment of the United States Bankruptcy Court, and directs the Clerk of the Court to enter final judgment in favor of Ernst & Young.

Because the June Order addressed the factual and procedural background of this case in full, the Court will not repeat the history of this case.

I. Standard on a Motion for Rehearing

When a party moves for reconsideration of a court order, Local Civil Rule 6.3 requires the movant

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[1] BSI argues that the Court necessarily considered, and rejected, each of Ernst & Young's arguments on appeal, notwithstanding the fact that the Court explicitly reserved judgment with respect to those arguments. In light of the fact that the Court called for additional briefing, the Court does not treat any of the issues not previously dealt with in the June Order as having been decided *sub silentio*.

[2] On August 5, 2004, Ernst & Young also filed a motion authorizing the termination of the supersedeas bond in whole or in part. That motion became fully briefed on August 12, 2004.

to identify "the matters or controlling decisions which counsel believes the court has overlooked." Local Civil Rule 6.3. The standard for reconsideration is "'strict in order to dissuade repetitive arguments in issues that have already been considered fully by the court.'" *Travelers Ins. Co.* v. *Buffalo Reinsurance Co.*, 739 F. Supp. 209, 211 (S.D.N.Y. 1990) (quoting *Caleb & Co.* v. *E.I. Du Pont de Nemours & Co.*, 624 F. Supp. 747, 748 (S.D.N.Y. 1985)); accord *Shrader* v. *CSX Transp., Inc.*, 70 F.3d 255, 257 (2d Cir. 1995). The Court does not, on a motion for reconsideration, reconsider arguments that it has already considered and rejected. *Travelers*, 739 F. Supp. at 211. This is so even if the Court considered but did not address, or did not address at length, a party's argument. See *Ades* v. *Deloitte & Touche*, 843 F. Supp. 888, 893 (S.D.N.Y. 1994); *Market St. Ltd. Partners* v. *Englander Capital Corp.*, 1993 U.S. Dist. LEXIS 10002, No. 92 Civ. 7434 (LMM), 1993 WL 276062, at *1 (S.D.N.Y. July 21, 1993). A motion for reconsideration "is not a substitute for appeal." *Morales* v. *Quintiles Transnational Corp.*, 25 F. Supp. 2d 369, 372 (S.D.N.Y. 1998).

Ernst & Young asks the Court to reconsider only two of the Court's conclusions in the June Order: (1) the Court's conclusion that pursuant to Second Circuit law, BSI has standing to assert CBI's negligence and breach of contract claims, notwithstanding the fact that BSI may not have standing to assert CBI's fraud claims, see June Order, 41-46; and (2) the Court's conclusion that pursuant to Second Circuit law, BSI has standing to assert TCW's fraud claims, because "a claim against a third party for defrauding a corporation with the cooperation of management accrues to creditors * * *.", see id. at 46-47 (citing *Shearson Lehman Hutton, Inc.* v. *Wagoner*, 944 F.2d

114, 120 (2d Cir. 1991)). The remainder of Ernst & Young's arguments on the motion for rehearing urge the Court to rule on issues that the Court expressly declined to consider in the June Order. Thus, the Court applies the standard for a motion for reconsideration only with respect to the two claims that Ernst & Young is asking the Court to reconsider; the Court will consider the remaining arguments contained in the motion for rehearing on their own merits.

II. Analysis

A. BSI's Standing to Assert CBI's Fraud Claims Against Ernst & Young

In the June Order, the Court held that the fraudulent acts of certain members of CBI's management will be imputed to CBI itself—and will consequently strip BSI of standing to assert CBI's fraud claims—unless the managers "totally abandoned" CBI's interests, and acted "entirely" for their own or another's interest (this exception is also referred to as the "adverse interest" exception). See June Order, 28-41 (discussing, inter alia, *Center* v. *Hampton Affiliates, Inc.*, 66 N.Y.2d 782, 785, 488 N.E.2d 828, 497 N.Y.S.2d 898 (1985); *Wight* v. *Bankamerica Corp.*, 219 F.3d 79, 87 (2d Cir. 2000); and *Mediators, Inc.* v. *Manney* (*In re Mediators, Inc.*), 105 F.3d 822, 827 (2d Cir. 1997)). Rather than immediately decide whether the "adverse interest" exception was properly applied by the Bankruptcy Court below, however, the Court deferred judgment on that question until after the Court resolved the issue of whether Ernst & Young was now entitled to a jury trial on these claims. See June Order, 34-35.

Ernst & Young argues that there is no evidence in the record to support the finding of "total abandonment," and thus that the Court need not decide the jury trial issue (*i.e.*, if the Court can conclude that there is insufficient evidence on the record for *any* trier of fact, whether it be the Bankruptcy Court below or some future jury, to conclude that CBI's managers "totally abandoned" CBI's interests, the Court need not decide whether a new trial is required). The Court agrees. Having reviewed the extensive record developed below, the Court finds that BSI has not met its burden of proving that CBI's managers "totally abandoned" CBI's interests when they committed their fraudulent acts.

BSI's claim that CBI's managers totally abandoned CBI's interests is premised on one exhibit and a portion of the testimony of Brian Mahoney, a former accounting supervisor at CBI. The exhibit upon which BSI relies is a vaguely worded schedule regarding the financial scenario that would need to occur "to reach 100 percent of bonus." DX 1018 (RE 1238).[3] The text of the exhibit was found by an Ernst & Young employee, on the computer used by John O'Brien, the former Controller of CBI. Although BSI and the Bankruptcy Court below treat this document as evidence of the intention of CBI's managers in defrauding the company,[4] Ernst & Young correctly

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[3] References to "RE" are references to portions of the record in this action (the "Record Excerpts") submitted by Ernst & Young.

[4] The Court notes that this is the only evidence relied upon by the Bankruptcy Court to support the finding of total abandonment. See *In re CBI Holding Co., Inc.*, 247 B.R. 341, 360 (Bankr. S.D.N.Y. 2000) (citing DX 1018 as support for the conclusion that "A principle [sic] reason why such members of CBI

points out here that the Bankruptcy Court declined to admit this document for that purpose, because the document was not authenticated. (RE 205). There is no testimony by O'Brien concerning the document; there is no indication of who created the document and for what purpose it was created. There is thus no basis to conclude that the document provides any evidence of O'Brien's intent in participating in the scheme to defraud CBI. The Mahoney testimony relied upon by BSI (but not the Bankruptcy Court below) to prove "total abandonment" is Mahoney's testimony that O'Brien told him that the "real reason" for failing to record liabilities and for overstating CBI's income was to ensure that Castello received his maximum bonus. (RE 265). Even if Mahoney's testimony, which is clearly hearsay, were admissible as an exception to the hearsay rule, its probative value is slight, in view of Mahoney's testimony immediately thereafter that he had no way of knowing whether O'Brien had some other purpose in mind for failing to record liabilities. (RE 266). Because the central issue for analyzing "total abandonment" is whether the managers were *simultaneously* serving their own interests and the company's interests, Mahoney's testimony lacks probative value.

Although it is not Ernst & Young's burden to prove that BSI *lacks* standing to bring CBI's claims, it is worth noting by way of contrast that the record

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management caused liabilities to remain unrecorded at year-end was not for any corporate purpose but rather to ensure that Castello received the maximum possible bonus and remained in control.") As the Court explained in the June Order, even this conclusion is insufficient to support a finding of total abandonment, because it is BSI's burden to prove that the defrauding managers of CBI had *no corporate purpose* for their acts of fraud, not that their *principal purpose* was personal.

contains some evidence that various corporate purposes were served by the managers' acts of fraud, at least some of which were distinct from the issue of Castello's bonus. For instance, CBI's managers hid invoices and left certain liabilities unrecorded in order to give false representations of CBI's profitability to lending banks, without which CBI would have risked triggering an event of default. (RE 293, 295). The Court also agrees with Ernst & Young that an adverse inference ought to be drawn from the fact that BSI chose not to offer any testimony by Paul Rogers, CBI's former senior financial officer. Rogers was allegedly a central figure in the fraud, and he thus possessed first-hand knowledge about the "real reason(s)" for the fraud. His settlement agreement with the Official Committee of Unsecured Creditors of the Debtors, approved by the Bankruptcy Court below, included an agreement by Rogers "to cooperate and assist the Committee, TCW, and the Disbursing Agent in connection with any litigation or claim they may have against * * * any present or former professional person retained by the Debtors. This cooperation shall include without limitation testifying at any deposition or trial at the request of the Committee or TCW." (RE 808-09). The fact that BSI did not call Rogers to testify to the fact that CBI's managers had "totally abandoned" CBI's interests in conducting the fraud, and were serving only their own interests, thus warrants an adverse inference.

Having conducted a full review of the record on appeal, the Court concludes that BSI cannot meet its burden of proving that the defrauding managers of CBI "totally abandoned" CBI's interests, and acted "entirely" for their own or another's interest. The Court thus holds that BSI does not have standing to assert CBI's fraud claims, and reverses the portion of

the Bankruptcy Court's decision below that holds otherwise.

B. BSI's Standing to Assert CBI's Negligence and Breach of Contract Claims Against Ernst & Young

In the June Order, this Court concluded that regardless of whether BSI has standing to sue Ernst & Young for defrauding CBI, BSI has standing to assert CBI's negligence and breach of contract claims against Ernst & Young. The basis for the Court's conclusion was its determination that the allegations giving rise to CBI's negligence and breach of contract claims were "clearly distinct" from the allegations premised on management's fraud. The Court also noted that its decision was supported by New York's contributory negligence scheme.

Ernst & Young urges the Court to reconsider this holding, and to instead treat CBI's breach of contract, negligence, and fraud claims as "a single form of wrongdoing under different names" for purposes of the standing analysis. See *Hirsch* v. *Arthur Andersen & Co.*, 72 F.3d 1085, 1092 (2d Cir. 1995) (citing *Cenco Inc.* v. *Seidman & Seidman*, 686 F.2d 449, 453 (7th Cir. 1982). In the Court's June Order, the Court overlooked the fact that the *Hirsch* Court approved of the principle explained in *Cenco*.

Having reviewed the parties' briefs on appeal, the Court concludes that its earlier holding was in error. The factual allegations giving rise to CBI's negligence and breach of contract claims are virtually identical to the allegations giving rise to CBI's fraud claims; all of CBI's claims are premised on allegedly deficient auditing by Ernst & Young that failed to discover fraudulent acts committed by cer-

tain members of CBI's management.[5] The only difference among the claims is the legal rubric within which the same conduct will be analyzed (was the conduct (1) in breach of the contractual agreement between CBI and Ernst & Young, (2) negligent and in contravention of Generally Accepted Auditing Standards, and/or (3) reckless and/or fraudulent).[6] The claims assert "a single form of wrongdoing under different names" for purposes of the standing analysis.[7]

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[5] The parties do not dispute that certain members of CBI's management committed the fraudulent acts that Ernst & Young failed to uncover in its audits, and that those members of management knowingly and purposely deceived Ernst & Young by, *inter alia*, providing Ernst & Young with CBI Management Representation Letters prior to the issuance of the 1993 and 1994 audit reports, containing numerous known misrepresentations. (RE 118-123).

[6] The fact that one of CBI's fraud claims arises out of the 1994 reaudit is immaterial; the Court previously noted that it is quite clear that the reaudit work was directly connected to Ernst & Young's 1993 and 1994 audits. See June Order, 18 n.4.

[7] In the June Order, the Court referred to New York's comparative negligence statute, and assumed that it provided some additional justification for treating CBI's negligence claims differently from the fraud and breach of contract claims. See June Order, 45-46. The two are in fact distinct: the *Wagoner* standing rule circumscribes which parties may bring a suit; New York's comparative negligence statute governs the apportionment of damages between multiple liable parties. See *Am. Tissue, Inc.* v. *Donaldson* 351 F. Supp. 2d 79, 2004 U.S. Dist. LEXIS 15732, No. 03 Civ. 6913 (GEL), 2004 WL 1794495, at *10 n.16 (S.D.N.Y. Aug. 10, 2004); *Am. Tissue, Inc.* v. *Arthur Andersen, L.L.P.*, 2003 U.S. Dist. LEXIS 22137, No. 02 Civ. 7751(SAS), 2003 WL 22909155, at *3-*4 (S.D.N.Y. Dec. 9, 2003).

For the foregoing reasons, BSI lacks standing to assert CBI's breach of contract and negligence claims against Ernst & Young.

C. BSI's Standing to Assert TCW's Fraud and Negligence Claims Against Ernst & Young

In the June Order, this Court concluded that BSI has standing to assert TCW's fraud claim against Ernst & Young, because "a claim against a third party for defrauding a corporation with the cooperation of management accrues to creditors," June Order, 46-47 (quoting *Wagoner*, 944 F.2d at 120), and because TCW had assigned that claim to BSI pursuant to the First Amended Joint Plan of Reorganization of Creditors' Committee and Debtors. (RE 798(a)).

Ernst & Young argues in its motion for rehearing that the Court overlooked controlling law, which holds that a bankruptcy trustee does not have standing to assert claims against third parties on behalf of creditors of a corporation, even where the creditors assigned their claims to the trustee. See *Breeden* v. *Kirkpatrick & Lockhart LLP* (*In re Bennett Funding Group, Inc.*), 336 F.3d 94, 102 (2d Cir. 2003) ("'Even when defrauded creditors assigned to the trustee their claims against another for aiding and abetting the fraud the trustee lacked capacity to sue.'") (quoting *Wagoner*, 944 F.2d at 118 (citing *Barnes* v. *Schatzkin*, 215 A.D. 10, 13, 212 N.Y.S. 536 (N.Y. App. Div. 1925))). Although BSI is not a bankruptcy trustee, both the Bankruptcy Court below and this Court have treated BSI as analogous to a trustee, because both sue in the shoes of the bankrupt's estate. See June Order, 30 (citing *Wight* v. *Bankamerica Corp.*, 219 F.3d 79, 80 (2d Cir. 2000) (analogizing the position of the trustee to that of a party suing on be-

half of the debtor); *In re Mediators, Inc.*, 105 F.3d 822, 826 (2d Cir. 1997) (same). The parties do not challenge that analysis.

Ernst & Young is correct that Barnes is controlling law on this issue,[8] and that it holds that a bankruptcy trustee has standing to bring only those claims that could have been brought by the bankrupt prior to the inception of bankruptcy proceedings (*i.e.*, that a trustee does not have standing to bring claims belonging to creditors of the bankrupt corporation, notwithstanding the fact that those creditors assigned their claims to the trustee). See *Barnes*, 215 A.D. at 12. *Barnes* has been consistently followed by the Second Circuit. See, *e.g.*, *In re Bennett Funding Group, Inc.*, 336 F.3d at 102; *In re Mediators, Inc.*, 105 F.3d at 826; *Wagoner*, 944 F.2d at 118. Because BSI is analogous to a bankruptcy trustee, it does not have standing to bring any claims belonging to TCW, notwithstanding the fact that TCW assigned its claims to BSI.

III. Conclusion

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[8] The Court notes that until Ernst & Young's motion for rehearing, none of the parties involved in this case, and neither the Bankruptcy Court below, nor this Court, addressed *Barnes*, and its clear implications for BSI's ability to bring claims assigned to it by TCW. Even in Ernst & Young's motion for rehearing, Ernst & Young argues only that this principle bars BSI's claim on behalf of TCW for *fraud*, and does not argue that this principle also bars BSI's claim on behalf of TCW for *negligence*. Nevertheless, because standing is jurisdictional, the Court must consider it on appeal, and must even consider it *sua sponte* once the issue arises. See *Presbyterian Church of Sudan* v. *Talisman Energy, Inc.*, 244 F. Supp. 2d 289, 333 (S.D.N.Y. 2003) (citing *Pashaian* v. *Eccelston Props., Ltd.*, 88 F.3d 77, 82 (2d Cir. 1996)).

For the reasons stated above, the Court concludes that based upon the evidence in record, BSI does not have standing to bring CBI's fraud, negligence, and breach of contract claims. The Court also concludes that BSI does not have standing to bring TCW's fraud and negligence claims. Because CBI's claim for expungement of Ernst & Young's Proof of Claim is premised upon CBI's allegations of fraud, breach of contract, and negligence, CBI's expungement claim necessarily fails. The Court thus vacates the judgment of the Bankruptcy Court in full, and authorizes Ernst & Young to terminate the supersedeas bond that it posted to secure a stay of that judgment pending appeal.

The Court thus (1) GRANTS Ernst & Young's motion for rehearing [Document # 36]; (2) GRANTS Ernst & Young's motion for relief from the supersedeas bond [Document # 42]; (3) vacates in full the judgment entered by the Bankruptcy Court below; and (4) directs the Clerk of Court to enter final judgment in favor of Ernst & Young. The Clerk of the Court is directed to close this appeal. Any pending motions are moot.

SO ORDERED.

APPENDIX C

[Opinion of the United States District Court For the Southern District of New York (June 30, 2004)]

United States District Court, Southern District of New York.

In re CBI HOLDING COMPANY, INC., et al., Debtors,

Ernst & Young and Ernst & Young, LLP, Appellants,

v.

Bankruptcy Services, Inc., Appellee.

Bankruptcy No. 94-B-43819 (BRL).

Adversary No. 01-CIV-0131 (KMW).

June 30, 2004.

WOOD, U.S.D.J.:

Ernst & Young and Ernst & Young, LLP (collectively, "Ernst & Young") appeal from a judgment of the United States Bankruptcy Court (Burton R. Lifland, Judge) in an adversary proceeding. The bankruptcy court found Ernst & Young liable for breach of contract, negligence, negligent misrepresentation and fraud in connection with Ernst & Young's pre-petition auditing of the financial statements of a company that petitioned for bankruptcy. The bankruptcy court entered judgment against Ernst & Young for approximately $ 70 million, and

expunged Ernst & Young's $ 210, 850 Proof of Claim against the company.

For the reasons set forth below, the Court affirms in part and reverses in part the decision of the bankruptcy court. The Court does not now remand this action to the bankruptcy court, but rather orders the parties to submit additional briefing.

I. Factual Background

The following facts are derived from the bankruptcy court's April 5, 2000 decision regarding liability, see *In re CBI Holding Co.*, 247 B.R. 341, 364-65 (Bankr. S.D.N.Y. 2000), and from the record on appeal. The Court takes from the record on appeal only those facts that are consistent with the bankruptcy court's findings and that are uncontested by the parties.

Prior to bankruptcy, CBI Holding Company, Inc., in conjunction with its subsidiaries (collectively, "CBI" or "Debtors"), was a large wholesale distributor of pharmaceutical products. As a wholesale distributor, CBI's business was to purchase pharmaceutical products from manufacturers, and warehouse those products for delivery to entities such as retail pharmacies and hospitals. CBI achieved its size during the early 1990s by pursuing a strategy of growth through acquisition. CBI financed its acquisitions in two ways.

First, CBI borrowed capital from a bank syndicate through a series of lending agreements. The lending agreements limited the amount of money that CBI could borrow, based on a formula dependent upon the inventory and accounts receivable of each CBI subsidiary. The greater the inventory and accounts receivable that conformed to certain eligi-

bility requirements, the more CBI could borrow, up to specified limits. The lenders ensured CBI's compliance with the limitations in the lending agreements by requiring CBI to submit periodic reports detailing earnings, inventory, and receivables.

Second, CBI acquired capital from Trust Company of the West ("TCW"), which invested in CBI in May 1991 and again in April 1993. In May 1991, TCW invested $20 million in CBI, and received in return $5 million in shares of CBI common stock (48% of all shares) and $15 million in corporate notes. In April 1993, TCW invested an additional $ 750,000 in CBI, and received a note with a face value in that amount, plus $250,000 worth of shares of common stock.

As a result of the May 1991 investment, TCW acquired various rights, which are set forth in a shareholders agreement dated May 31, 1991 (the "Shareholders Agreement"), and a securities purchase agreement dated May 31, 1991 (the "Securities Agreement"). Pursuant to the Shareholders Agreement, TCW had the right to select two of the five members of CBI's board of directors and one of the three members of the board's audit committee. CBI's president and CEO, Robert Castello ("Castello"), held the remaining 52% of shares of CBI common stock. With that share of ownership, Castello had the right to select the remaining members of the board of directors and the audit committee. TCW also received certain contingent rights to take control of CBI. Pursuant to the Shareholders Agreement, TCW had the right to take control of CBI in the event of the occurrence of a "control triggering event." The Shareholders Agreement defined control triggering events to include (1) a breach of the earnings to fixed charge

ratio specified in the Securities Agreement, and (2) a failure to pay principal on TCW's corporate notes, whether such payment was due at maturity or by reason of acceleration. TCW had the right to accelerate payment on its notes, pursuant to the Securities Agreement, in the event of a failure by CBI to comply in any material respect with certain covenants in the Securities Agreement. Those covenants established the earnings to fixed charge ratio and included a prohibition against certain transactions, including loans to CBI's officers.

The compensation agreement between Castello and CBI provided for a bonus payment for Castello that was tied to CBI's earnings. Castello received a bonus for fiscal year 1992 that was tied to fiscal year 1992 earnings. Castello also caused a portion of his bonus for fiscal year 1993 to be paid to him before it was due.

In fiscal years 1992 and 1993, CBI's management, including Castello, participated in the misrepresentation of CBI's inventory, the misrepresentation of the age of certain of CBI's receivables, and the intentional failure to record certain of CBI's liabilities.

Ernst & Young was the pre-bankruptcy accounting firm for Debtors. Ernst & Young issued unqualified audit opinions with respect to Debtors' financial statements for fiscal years 1992 and 1993. Ernst & Young issued its fiscal year 1992 opinion on August 6, 1992, and its fiscal year 1993 opinion on October 26, 1993. For each of those years, Ernst & Young's opinions stated, *inter alia*, that Ernst & Young conducted its audit in accordance with Generally Accepted Accounting Standards ("GAAS") and that, in the opinion of Ernst & Young, the consolidated financial statements presented fairly, in all material

respects, the financial position of Debtors. In actual fact, the financial statements prepared by Ernst & Young did not present fairly, in all material respects, the financial position of Debtors because Ernst & Young did not detect certain unrecorded liabilities when it performed the fiscal 1992 and 1993 audits. In March 1994, Ernst & Young acknowledged that Debtors' 1993 financial statements were materially inaccurate and withdrew its October 23, 1993 opinion. Also in March 1994, Ernst & Young commenced additional procedures related to the financial statements of CBI for fiscal year 1993 (the "re-audit"). Ernst & Young never completed the re-audit because, in July 1994, CBI directed it to cease all audit-related activities.

II. Procedural History

A. The Bankruptcy Proceeding

In August 1994, Debtors filed a petition for relief under Chapter 11 of the Bankruptcy Code. In January 1995, Ernst & Young filed a Proof of Claim against CBI in those proceedings in the amount of $210,850 for allegedly unpaid auditing and consulting services (the "Proof of Claim"). The Proof of Claim states that the claim "arises from professional services rendered in 1993 and 1994 on behalf of Debtor in connection with the audit of Debtor's financial statements and other special engagements as described in the attached Exhibits." (RE 780).[1] Those

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[1] References to "RE" are references to portions of the record in this action (the "Record Excerpts") submitted by Ernst & Young. By order dated January 24, 2002, this Court permitted BSI to supplement Ernst & Young's Record Excerpts and to submit a brief that references those excerpts by February 1, 2002. No supplement was ever submitted.

Exhibits are seven invoices dated between May 12, 1994 and August 5, 1994. In June 1995, the Official Committee of Unse-cured Creditors of Debtors (the "Creditors' Committee") filed an objection to certain claims filed in Debtors' bankruptcy action, including the claim filed by Ernst & Young. The objection does not allege malpractice but states that it is "without prejudice to the Committee's right to object to the' within proofs of claim on other grounds as may be necessary." (Affirmation of Michael L. Schein, dated October 17, 1996 (filed in 96 Civ. 7969) Ex. E, at 9).

By order dated August 23, 1995, the bankruptcy court confirmed the First Amended Joint Plan of Reorganization of Creditors' Committee and Debtors (the "Plan"). In that order, the bankruptcy court appointed Bankruptcy Services, Inc. ("BSI"), the appellee in this action, as the disbursing agent of the Plan. The Plan "provides for the liquidation of all of the Debtors' Assets and the prosecution of various litigations on behalf of the Debtors against third parties (other than the TCW Entities) and the distribution of the net proceeds thereof to the holders of Allowed Claims in accordance with applicable bankruptcy law and this Plan." (RE 795). Under the Plan, Debtors granted to BSI, *inter alia*, "the right to pursue and prosecute * * * all adversary proceedings and contested matters pending or thereafter commenced or filed in the Bankruptcy Court or elsewhere, including * * * any and all objections to claims." (RE 798). The Plan also provided that Debtors "shall be deemed to have waived and released any and all claims * * * against TCW," and that TCW "shall receive an [allowed claim] of $16.7 million," and shall "be deemed to have transferred and assigned to the Disbursing Agent, any and all rights to pursue and prosecute causes of action of any kind held by TCW

against any third party, in its capacity as a Creditor or equity security holder of any of the Debtors." (RE 798a).

B. The Adversary Proceeding

On October 16, 1996, BSI, in its capacity as the Disbursing Agent under the Plan, filed a complaint in bankruptcy court against Ernst & Young (the "Adversary Proceeding"). On October 25, 1996, the Creditors' Committee and BSI entered into an assignment under which the Creditors' Committee expressly assigned to BSI its "right, title and interest to pursue and prosecute all adversary proceedings and contested matters pending as of the Effective Date of the Plan or thereafter commenced or filed in the Bankruptcy Court or elsewhere including, without limitation, the Litigations and objection to claims, inclusive of the Objection to the claim of [Ernst & Young]."

On or about October 25, 1996, BSI filed an amended complaint, alleging the assignment of Debtors' and TCW's claims against Ernst & Young, and the assignment of the Creditors' Committee's Objection to Ernst & Young's Proof of Claim. The amended complaint concerns professional services rendered by Ernst & Young to Debtors from 1992 to 1994. Specifically, BSI alleges: (1) breach of contract in connection with the fiscal 1992 and 1993 audits; (2) negligence in connection with the fiscal 1992 and 1993 audits; (3) negligent misrepresentation that the fiscal year 1992 and 1993 financial statements were materially accurate and that Ernst & Young conducted the fiscal 1992 and 1993 audits in compliance with GAAS; (4) fraud and/or recklessness in connection with the fiscal 1992 and 1993 audits; (5) fraud and/or recklessness in inducing Debtors to retain

Ernst & Young to perform the reaudit; (6) breach of fiduciary duty in failing to make certain disclosures to CBI; and (7) expungement of Ernst & Young's $210,850 Proof of Claim. BSI brought each of these claims as assignee of the claims of Debtors. Had CBI not filed for bankruptcy, the claims of Debtors would belong to Castello (52% shareholder) and to TCW as an equity holder in CBI (48% shareholder). The Court refers to these claims as "CBI's claims." The second, third, fourth, and fifth claims are also brought by BSI as assignee of the claims of TCW as a creditor of CBI. The Court refers to these claims as "TCW's claims." The bankruptcy court dismissed the breach of fiduciary duty claim by order dated April 21, 1999.

In the amended complaint, BSI alleges damages to CBI in the form of expenditures that would not have been made but for Ernst & Young's misconduct (*e.g.*, Castello's bonuses and base salary, fees for certain acquisitions, and fees paid to Ernst & Young), the loss of Debtors' value as a going concern, and increased losses and/or liabilities incurred after fiscal year 1992. BSI alleges damages to TCW representing TCW's loss with respect to its equity interest in Debtors and its loss with respect to its $15 million note.

Soon after the filing of BSI's amended complaint, Ernst & Young moved to withdraw the Adversary Proceeding from bankruptcy court to this Court. By order dated November 13, 1998 (the "1998 Order"), the Court denied that motion, concluding that the Adversary Proceeding qualified as a "core" proceeding under 28 U.S.C. § 157(b)(2), and specifically as a "counterclaim" under § 157(b)(2)(C) and as a proceeding concerning the "allowance or disallowance of

claims against the estate" under § 157(b)(2)(B).[2] See 1998 Order, 6-10. The Court based that conclusion on its determination that the Proof of Claim and the claims in the amended complaint "are related, arise out of the same transaction, and a determination of [BSI's] claims would likely be dispositive of [Ernst & Young's] claims." *Id.* at 7. The Court also held that the interests of judicial economy would be best served by leaving the adversary proceeding in the bankruptcy court, given Judge Lifland's familiarity with the issues and the parties. See *id.* at 11-12.

In December 1998, Ernst & Young moved for re-argument and reconsideration of the 1998 Order. While that motion was pending, two other orders relevant to this appeal were issued. First, the bankruptcy court issued an order in May 1999 that, *inter alia*, bifurcated the trial on liability from the determination of damages. Second, in June 1999, Judge Baer, acting in Part I on an application by Ernst & Young, issued an order to show cause that the reference to bankruptcy court for purposes of trial should not be withdrawn. By order dated July 1, 1999, this Court vacated the order to show cause and stated that it would consider Ernst & Young's arguments in support of the order to show cause in conjunction with Ernst & Young's motion for reconsideration.

The Court denied Ernst & Young's motion for reconsideration, by order dated August 13, 1999 (the

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[2] The Court also found that the claims are core matters under the "catch-all" provisions of § 157(b)(2) (A) ("matters concerning the administration of the estate") and (0) ("other proceedings affecting the liquidation of the assets of the estate or the adjustment of the debtor-creditor or the equity security holder relationship, except personal injury tort or wrongful death claims"). See 1998 Order, 10-11.

"1999 Order"). In the 1999 Order, the Court rejected Ernst & Young's argument that the bankruptcy court could not properly hear the claims between TCW and Ernst & Young because they are two, non-debtor, third parties. See 1999 Order, 3-4. The Court determined that, because all of the claims asserted by BSI, including those assigned to it by TCW, involved Debtors or Debtors' property, those claims were properly deemed to be core. See *id.* The Court also affirmed its earlier finding, made in the 1998 Order, that BSI's claims constitute counterclaims to Ernst & Young's Proof of Claim, and rejected Ernst & Young's claim that the Creditors' Committee's assignment was ineffective. *Id.* at 4-5. Finally, the Court concluded that, to the extent the parties were protected by the Seventh Amendment, the bankruptcy court could conduct a jury trial without the consent of the parties. *Id.* at 8-10. The Court did not rule on whether CBI's claims could be tried without a jury.

By order dated September 3, 1999, the bankruptcy court struck Ernst & Young's jury trial demand, finding that Ernst & Young had no right to a jury trial.

After a bench trial on the issued of liability, the bankruptcy court issued its April 5, 2000 decision and granted "judgment" for CBI "on all remaining counts." *In re CBI Holding*, 247 B.R. at 369. The bankruptcy court did not discuss separately each of CBI's six claims and each of TCW's four claims, but instead stated the following conclusions: (1) Ernst & Young departed from GAAS in conducting the fiscal year 1992 and 1993 audits of Debtors' financial statements; (2) Ernst & Young's departure from GAAS was the proximate cause of injury to CBI and

TCW; (3) the fact that the accounting fraud was known by Castello and other management employees does not deprive CBI (and BSI acting on CBI's behalf) of standing to assert its claims of auditor malpractice; (4) TCW (and BSI acting on TCW's behalf) has standing to assert both negligence and fraud claims against Ernst & Young; and (5) TCW's claims are not barred by New York General Obligation Law section 15-108(c). In its April 5, 2000 decision, the bankruptcy court did not state any specific conclusion with respect to BSI's claim for expungement of Ernst & Young's Proof of Claim.

By order dated April 18, 2000, the bankruptcy court stated specifically that it had found Ernst & Young liable to BSI on BSI's first through fifth claims, and scheduled trial on damages. After a second bench trial, the bankruptcy court determined damages of $27,738,603, plus pre-judgment interest of over $17,000,000, with respect to the claims brought by BSI on behalf of CBI, and damages of $15,412,000, plus pre-judgment interest of nearly $10,000,000, with respect to the claims brought by BSI on behalf of TCW. The bankruptcy court found that the appropriate measure of damages suffered by CBI is the difference in the amount for which CBI's equity could have been sold in 1993 and $0 (CBI's value at the time the Plan was entered on August 23, 1995). The bankruptcy court found that the appropriate measure of damages suffered by TCW is the amount TCW would have received on its $15.75 million in notes if CBI had been sold in October 1993. The bankruptcy court thus awarded damages to TCW only as a creditor and not as an equity security holder of CBI.

In its final judgment in this action, dated November 6, 2000, the bankruptcy court stated that, in its April 5, 2000 decision, it "found [Ernst & Young] liable to [BSI] on each of Counts I through V and found that with respect to Count VII that [sic] [Ernst & Young's] proof of claim in the bankruptcy proceeding in the amount of $210,850 should be expunged." The bankruptcy court again did not explain its reasons for expunging the Proof of Claim.

Ernst & Young now appeals the bankruptcy court's decisions concerning liability and damages.

III. Discussion

In exercising appellate jurisdiction, a district court reviews the bankruptcy court's findings of fact for clear error, and its conclusions of law *de novo*. A court reviews mixed questions of fact and law *de novo*. See *In re Vebeliunas*, 332 F.3d 85, 90 (2d Cir. 2003); *In re AroChem Corp.*, 176 F.3d 610, 620 (2d Cir. 1999).

Ernst & Young raises seven arguments on appeal. First, it renews its argument that BSI's claims are not "core" and thus were not properly within the jurisdiction of the bankruptcy court. Second, it argues that it is constitutionally entitled to a jury trial on BSI's claims against it and that the bankruptcy court improperly struck Ernst & Young's jury trial demand. Third, it contends that the bankruptcy court erred in refusing to impute the wrongdoing of CBI's senior management to CBI. Fourth, it asserts that the bankruptcy court erred in finding that Ernst & Young's alleged malpractice was the legal cause of CBI's and TCW's asserted injuries. Fifth, it challenges the bankruptcy court's findings of negligence and fraud. Sixth, it argues that TCW's claims are

barred by New York statute and by TCW not having been in privity with Ernst & Young. And, seventh, it argues that the bankruptcy court erred in its determination of damages.

A. The Court's Determination that BSI's Claims are Core

The Court has twice ruled that BSI's claims against Ernst & Young are "core" proceedings under the Bankruptcy Code that can be determined by a bankruptcy judge. See 28 U.S.C. § 157(b)(1). Ernst & Young does not reargue the jurisdictional issue in this appeal but states its continued objection to the Court's conclusion, and offers to provide plenary argument if the Court decides to revisit the issue. Ernst & Young also sets forth the principal bases for its position that a bankruptcy judge had no jurisdiction to try either the CBI claims or the TCW claims.

The Court declines to entertain a complete reargument of the jurisdictional issue. The Court does, however, take this opportunity to reiterate and further explain its reasons for determining that the CBI claims and the TCW claims are core.

Section 157 of the Bankruptcy Code divides claims in bankruptcy proceedings into two principal categories, "core" and "non-core." See *S.G. Phillips Constructors, Inc.* v. *City of Burlington* (*In re S.G. Phillips Constructors, Inc.*), 45 F.3d 702, 704 (2d Cir. 1995). "Bankruptcy judges may hear and determine all cases under title 11 and all core proceedings arising under title 11 or arising in a case under title 11 * * *, and may enter appropriate orders and judgments, subject to review under section 158 of [title 28]." 28 U.S.C. § 157(b)(1). Bankruptcy judges may hear non-core proceedings "that [are] otherwise re-

lated to a case under title 11" but, absent consent of the parties, may only recommend findings of fact and conclusions of law, which are subject to *de novo* review by a district court. 28 U.S.C. § 157(c).

The distinction between core and non-core proceedings derives from the Supreme Court's decision in *Northern Pipeline Construction Co.* v. *Marathon Pipe Line Co.*, 458 U.S. 50 (1982). See *In re United States Lines, Inc.*, 197 F.3d 631, 636 (2d Cir. 1999). In *Marathon*, the Supreme Court struck down portions of the 1978 Bankruptcy Act and held that only Article III judges can adjudicate legal disputes that are not "at the core of the federal bankruptcy power." 458 U.S. at 71. The Supreme Court ruled specifically that Congress could not constitutionally give a bankruptcy court "the authority to adjudicate a state breach-of-contract action, based on a pre-petition contract, brought by a debtor against a defendant that had not filed a claim with the bankruptcy court." *In re Orion Pictures Corp.*, 4 F.3d 1095, 1100 (2d Cir. 1993).

Congress enacted 28 U.S.C. § 157 in response to *Marathon*. Section 157 provides a non-exclusive list of core proceedings, which includes, *inter alia*, matters concerning the administration of the estate, allowance or disallowance of claims against the estate, counterclaims by the estate against persons filing claims against the estate, and other proceedings affecting the liquidation of the assets of the estate or the adjustment of the debtor-creditor relationship. Both the Second Circuit and the Supreme Court "have concluded that the *Marathon* holding was a narrow one and have broadly construed the jurisdictional grant" in 28 U.S.C. § 157. *In re S.G. Phillips Constructors, Inc.*, 45 F.3d at 705. "'Core proceed-

ings' should be given a broad interpretation that is 'close to or congruent with constitutional limits.'" *In re United States Lines, Inc.*, 197 F.3d at 637 (quoting *In re Best Prods. Co.*, 68 F.3d 26, 31 (2d Cir. 1995) (quoting *In re Arnold Print Works, Inc.*, 815 F.2d 165, 168 (1st Cir. 1987))). However, "[a] general rule that * * * proceedings are core [simply] because they involve the property of the estate would 'create[] an exception to *Marathon* that would swallow the rule.'" *In re United States Lines, Inc.*, 197 F.3d at 637 (quoting *In re Orion Pictures Corp.*, 4 F.3d at 1102).

In the context of evaluating whether contract[3] actions are core proceedings, the Second Circuit has stated that the determination depends on "(1) whether the contract is antecedent to the reorganization petition; and (2) the degree to which the proceeding is independent of the reorganization." *In re United States Lines, Inc.*, 197 F.3d at 637. The fact that an action arises out of a pre-petition contract weighs against that proceeding being deemed "core". See *Luan Inv. S.E.* v. *Franklin 145 Corp.* (*In re Petrie Retail, Inc.*), 304 F.3d 223, 229 (2d Cir. 2002) (citing *In re United States Lines, Inc.*, 197 F.3d at 637-38). Similarly, the greater the degree of independence between the reorganization and a particular cause of action, the less likely it is that the action will be deemed core. The degree of independence "hinges on 'the nature of the proceeding.'" *In re*

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[3] Although the present case involves predominantly tort claims, the Court applies by analogy the framework developed by the Second Circuit with respect to contract claims. Cf. *Statutory Comm. of Unsecured Creditors* v. *Motorola, Inc.* (*In re Iridium Operating LLC*), 285 B.R. 822, 830 (S.D.N.Y. 2002) (stating that the test applies equally to contract actions and "non-personal injury tort actions").

United States Lines, Inc., 197 F.3d at 637 (quoting *In re S.G. Phillips Constructors, Inc.*, 45 F.3d at 707). "Proceedings can be core by virtue of their nature if either (1) the type of proceeding is unique to or uniquely affected by the bankruptcy proceedings, or (2) the proceedings directly affect a core bankruptcy function." *In re United States Lines, Inc.*, 197 F.3d at 637.

In this case, the Court determined that ten claims against Ernst & Young could be heard by the bankruptcy court, six of which were pursued on behalf of CBI and four of which were pursued on behalf of TCW. Nine out of ten of the claims (that is, all except CBI's expungement claim) are based on events that occurred before Debtors filed for bankruptcy. That factor cuts generally against a finding that the claims are core. Nonetheless, courts commonly find claims to be core based solely on the nature of the claims, despite the fact that those claims are based on pre-petition contracts. See, *e.g.*, *In re Petrie Retail, Inc.*, 304 F.3d at 229-231 (holding that a plan consummation motion was core, notwithstanding the fact that it was based on a pre-petition lease); *In re United States Lines, Inc.*, 197 F.3d at 638 (holding that a contract action was core, notwithstanding the fact that it was based on pre-petition contracts). The Court sets forth here a further explanation of its reasons for deciding that all of the claims in this case are core.

1. CBI's Claims are Core

CBI's claim for expungement of Ernst & Young's Proof of Claim is unquestionably core because it directly implicates a core bankruptcy function, *i.e.*, the allowance or disallowance of claims against the estate. See 28 U.S.C. § 157 (b)(2)(B); *In re S.G. Phillips*

Constructors, Inc., 45 F.3d at 705. CBI's five other claims (alleging negligence, breach of contract, and fraud) are core because they are factually and legally interconnected with Ernst & Young's Proof of Claim and CBI's expungement claim. See *In re Iridium Operating LLC*, 285 B.R. at 830-831 (S.D.N.Y. 2002) (claims that would otherwise be non-core are rendered core because they arise from the same operative facts as core claims and proofs of claim) (collecting cases).

The degree to which CBI's negligence, breach of contract, and fraud claims are interconnected with the Proof of Claim and expungement claim can be demonstrated by reference to CBI's fraud claim regarding the reaudit work. As Ernst & Young emphasizes in its brief on appeal, its Proof of Claim apparently concerned fees due for services performed in connection with the reaudit.[4] CBI's fraud claim with respect to the reaudit work specifically alleges that CBI was induced to continue to retain Ernst & Young to perform the reaudit work under false pretenses, because Ernst & Young had not revealed its

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[4] When the Court initially considered the core/non-core question, it was unclear what services Ernst & Young claimed in its Proof of Claim were uncompensated. Although the Proof of Claim states that it "arises from professional services rendered in 1993 and 1994," the attached exhibits detailing the services contained only invoices from 1994. Ernst & Young characterizes the Proof of Claim in its papers as having to do solely with the reaudit work (and it appears to be uncontested that the services at issue actually were performed only in 1994). Nonetheless, it is also quite clear that the reaudit work was directly connected to Ernst & Young's 1993 and 1994 audits. For example, a large portion of the work included in the Proof of Claim was apparently a "special review" of Debtors' financial statements after the discovery of the management fraud.

own culpability in failing to detect Debtors' unrecorded liabilities. BSI also argues that Ernst & Young's Proof of Claim essentially charges CBI for Ernst & Young's repetition of audit work that Ernst & Young performed improperly the first time around. The Court finds (as it found when it first considered this issue) that such a claim, if proven, could provide a defense to Ernst & Young's Proof of Claim. See, *e.g.*, *Altamore* v. *Friedman*, 193 A.D.2d 240, 247, 602 N.Y.S.2d 894 (2d Dep't 1993) ("malpractice is a defense to an action to recover for professional services"); *Bowen* v. *Merdinger*, 196 Misc. 987, 92 N.Y.S.2d 566, 571 (Sup. Ct. 1949) ("if by misrepresentation or suppression of facts, the plaintiffs were induced to enter into the agreement in suit, the agreement is not only voidable and subject to rescission at the instance of the injured party, but the defendant has also forfeited all right to compensation for services rendered").

The Court thus reaffirms its conclusion that CBI's reaudit fraud claim is core, because it would affect the allowance or disallowance of Ernst & Young's Proof of Claim, see 28 U.S.C. § 157(b)(2)(B), and states a counterclaim by the estate against a person filing a claim against the estate, see 28 U.S.C. § 157(b)(2)(C). Because CBI's remaining claims of negligence, breach of contract, and fraud are based upon the same operative facts as the reaudit fraud claim and the expungement claim, and were filed in response to Ernst & Young's Proof of Claim, which is based on the same set of facts, those claims are also deemed core. "A response to a proof of claim which is, in essence, a counterclaim, is a core proceeding under 28 U.S.C. § 157(b)(2)(C)." See *In re Baudoin*, 981 F.2d 736, 741 (5th Cir. 1993) (debtor's $4,000,000 contract and tort claims regarding loans were "core"

when creditor filed proof of claim based on same loans); *Leslie Fay Cos.* v. *Falbaum* (*In re Leslie Fay Cos.*), 1997 U.S. Dist. LEXIS 13431, No. 97 Civ. 2244 (MGC), 1997 WL 555607, *2 (S.D.N.Y. Sept. 4, 1997) ("The adversary proceeding is nothing more than a counterclaim by Leslie Fay to the proofs of claim filed by the Creditors" and is therefore core).

The Court also rejects Ernst & Young's argument that BSI cannot predicate CBI's claims on § 157(b)(2)(B) (allowance or disallowance of claims) because neither CBI nor BSI objected to Ernst & Young's Proof of Claim under the terms of the Plan. The Court finds that the Creditors' Committee's assignment to BSI of its objection to Ernst & Young's Proof of Claim was effective, in light of the nature, purpose, and terms of the Plan.

2. TCW's Claims are Core

TCW's negligence and fraud claims are in a slightly different posture than CBI's claims. There is no doubt that TCW's claims are implicated in the claims allowance process to the extent that those claims are factually congruent with the CBI negligence and fraud claims that form the basis of CBI's objection to Ernst & Young's Proof of Claim. However, because Ernst & Young's Proof of Claim was filed solely against CBI, and not TCW, BSI's claim to expunge the Proof of Claim is brought on behalf of CBI alone. TCW's claims cannot, therefore, be core pursuant to § 157(b)(2)(B), because they would not themselves directly affect the allowance or disallowance of the Proof of Claim.[5] To the extent the Court

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[5] The Court notes that BSI alleges its reaudit fraud claim on behalf of TCW as well as on behalf of CBI. Although TCW may have standing to assert a claim for damages for the alleged

did not make this point clear in its previous orders, it does so now.

TCW's claims do, however, qualify as counterclaims by the estate against persons filing claims against the estate. See 28 U.S.C. § 157(b)(2)(C). TCW's claims became the property of Debtors' estate under the Plan. Although the claims were deemed "transferred and assigned" to BSI, BSI was acting solely as a disbursing agent for Debtors under the Plan. The assignment to BSI in these circumstances was equivalent to an assignment to the estate. This assignment was not effected solely for the purpose of manufacturing jurisdiction over this adversary proceeding, cf., *In re Maislin Indus, U.S., Inc.*, 66 B.R. 614, 617 (E.D. Mich. 1986) (denying motion to amend complaint where assigned claims had no valid business purpose and no clear relationship to the bankruptcy proceeding), but was effected as an integral part of the Plan, which was approved by the bankruptcy court and over which the bankruptcy court retained jurisdiction. TCW's claims are counterclaims by the estate arising out of the facts that gave rise to Ernst & Young's Proof of Claim. In the unique circumstances of this case, the Court finds that the bankruptcy court had jurisdiction to adjudicate TCW's claims.[6]

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reaudit fraud, the Court sees no reason TCW would have standing, whether as a creditor or an equity security holder of CBI, to assert this claim as a defense to Ernst & Young's Proof of Claim for the reaudit work.

[6] The Court also rejects Ernst & Young's argument that, pursuant to 11 U.S.C. § 1141(b), the estate ceased to exist upon confirmation of the Plan, and that therefore TCW's claims could never have become property of the estate. The terms of the Plan are directly to the contrary. (R.E. 799 (e.g., the bankruptcy

The case at hand is distinguishable from certain cases in which courts have found adversary proceedings to be non-core or have granted motions to withdraw references from the bankruptcy court. This case is distinguishable from *Marathon* and *In re Orion Pictures Corp.* because Ernst & Young filed a Proof of Claim in Debtors' bankruptcy proceeding, and BSI's claims are factually and/or legally related to that Proof of Claim. This case is also distinguishable from *Complete Mgmt.* v. *Arthur Andersen*, 2002 U.S. Dist. LEXIS 18344, No. 02 CIV. 1736 (NRB), 2002 WL 31163878 (S.D.N.Y. Sept. 27, 2002) and *In re 131 Liquidating Corp.*, 222 B.R. 209, (S.D.N.Y. 1998), two decisions in which courts in this district granted motions to withdraw references from the bankruptcy court.[7]

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court retains exclusive jurisdiction to "enter a final decree closing the Debtors' estates")).

[7] *In re Complete Management, Inc.* is factually similar to this case to the extent that it concerned a malpractice claim by a debtor against an accounting firm that had filed a proof of claim in the debtor's bankruptcy proceeding. It is factually distinct to the extent that Judge Buchwald had a related securities action pending before her at the time she considered the accountant's withdrawal motion. Moreover, although Judge Buchwald expressed some skepticism that a counterclaim seeking damages far greater than the related proof of claim could be deemed core, she expressly declined to reach that issue. Instead, Judge Buchwald assumed, *arguendo*, that the adversary proceeding was core, and decided nonetheless to withdraw the reference because other "considerations of efficiency and fairness favored withdrawal." *In re Complete Management*, 2002 U.S. Dist. LEXIS 18344, 2002 WL 31163878, at *3. In this case, at the time Ernst & Young moved to withdraw the reference from the bankruptcy court, considerations of efficiency strongly weighed in favor of not granting that motion.

B. Ernst & Young's Right to a Jury Trial[8]

Ernst & Young appeals the bankruptcy court's decision that Ernst & Young does not have a Seventh Amendment right to a jury trial. It is well-established that the Seventh Amendment protects the right to a jury trial only for matters at law, "in contradistinction" to those in equity. *Granfinanciera, S.A.* v. *Nordberg*, 492 U.S. 33, 41 (1989) (quoting *Parsons* v. *Bedford, Breedlove & Robeson*, 28 U.S. (3 Pet.) 433, 447 (1830) (Story, J.)). The parties here do not contest that BSI's tort and contract claims in this action are traditionally legal in nature and thus that

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In *In re 131 Liquidating Corp.*, Judge Cederbaum found that a claim by the debtor's shareholders against three individuals who were principals of a creditor was non-core. She reasoned that the claim was non-core because it "arose under state common law and involves pre-petition conduct by parties who have no claim against the debtor," even though the non-core claim "arose out of the same transaction as [other] core claims." *In re 131 Liquidating Corp.*, 222 B.R. at 211. Although Ernst & Young analogizes its relationship to TCW to the relationship of the individual principals to the shareholders in *In re 131 Liquidating Corp.*, the analogy is inapt. The individual principals in *In re 131 Liquidating Corp.* had not filed any proof of claim in the debtor's bankruptcy proceeding (even though the creditor for whom they were principals had). Here, Ernst & Young has filed a Proof of Claim and, for the reasons stated above, BSI's claims are core.

[8] In any action commenced in federal court, the "right to a jury trial * * * is to be determined as a matter of federal law." *Simler* v. *Conner*, 372 U.S. 221, 222 (1963) (per curiam). Because the determination of the parties' right to a jury is one of law, the Court reviews the bankruptcy court's decision *de novo*. *In re Maxwell Newspapers, Inc.*, 981 F.2d 85, 89 (2d Cir. 1992); *Shoppers World Cmty. Ctr., L.P.* v. *Bradlees Stores, Inc.* (*In re Bradlees Stores, Inc.*), 2001 U.S. Dist. LEXIS 14755, Nos. 00-16033 (BRL), 00-16035 (BRL), 00-16036 (BRL), 01-CV-3934 (SAS), 2001 WL 1112308, *1 (S.D.N.Y. Sept. 20, 2001).

there is ordinarily a right to have them decided by a jury.[9]

Legal claims cannot be "'magically converted into equitable issues' merely because they arise out of [the] equitable proceedings" of the bankruptcy court. *Germain* v. *Connecticut Nat'l Bank*, 988 F.2d 1323, 1329 (2d Cir. 1993) (quoting *Ross* v. *Bernhard*, 396 U.S. 531, 538 (1970)). In addition, "the designation of an action as 'core' does not control whether or not the action may be tried before a jury * * * the determination that the * * * action is 'core' is entitled to minimal weight in reaching our ultimate decision on the jury trial issue." *Germain*, 988 F.2d at 1326. However, certain claims can lose their legal nature, and be converted into claims in equity, if the action in which the claims are brought is "integrally related" to the claims allowance process in bankruptcy. *Granfinanciera, S.A.* 492 U.S. at 60; *Germain*, 988 F.2d at 1329 & 1332. A claim is integrally related to the claims allowance process if it affects the allowance of a creditor's claim filed against the bankruptcy estate. *Id.* at 1327.

Because the filing of a claim against the bankruptcy estate triggers the process of "allowance and disallowance of claims," a creditor who files such a claim subjects itself to the bankruptcy court's equitable jurisdiction. *Granfinanciera*, 492 U.S. at 58. If that creditor is met with an adversary proceeding, the resolution of which affects the restructuring of debtor-creditor and creditor-creditor relations, then

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[9] Because the parties agree that the claims at issue are legal in nature, the Court need not undertake the analysis set forth in *Granfinanciera* to determine whether the action is legal or equitable. 492 U.S. at 42.

the creditor loses its Seventh Amendment rights, even if the adversary proceeding concerns traditionally legal claims. *Langenkamp* v. *C.A. Culp*, 498 U.S. 42, 44 (1990); *Granfinanciera*, 492 U.S. at 58-59 & 59 n.14. If, in contrast, the creditor does not submit a claim against the bankruptcy estate, it has not subjected itself to the bankruptcy court's equitable jurisdiction, and it, therefore, maintains its right to a jury for any claims arising out of the bankruptcy proceeding. *Langenkamp*, 498 U.S. at 45; *Granfinanciera*, 492 U.S. at 58-59. Accordingly, a creditor's right to a jury trial on traditionally legal claims arising in an adversary proceeding depends on: (1) whether the creditor has filed a proof of claim against the bankruptcy estate, see *Langenkamp*, 498 U.S. at 45 (quoting *Granfinanciera*, 492 U.S. at 58); and (2) whether the resolution of the proceeding affects the allowance of the proof of claim, see *Germain*, 988 F.2d at 1327.

Ernst & Young has filed a Proof of Claim against the bankruptcy estate; its right to a jury trial thus turns on whether the resolution of BSI's claims affects the allowance of Ernst & Young's Proof of Claim. To make this determination, the Court looks again to the relationship between Ernst & Young's Proof of Claim and the CBI and TCW claims.

1. Ernst & Young Does Not Have a Right to a Jury Trial on CBI's Claims

The Court finds that the claims assigned to BSI by CBI are integrally related to the claims allowance process because BSI's success on those claims would result in the disallowance of Ernst & Young's Proof of Claim. See *id.* at 1330, n.8 (discussing *In re Frost*, Inc., 145 B.R. 878, 882 (Bankr. W.D. Mich. 1992) (debtor's allegations of prepetition attorney malpractice are "intertwined" with debtor's objection to at-

torney's proof of claim for fees due, and thus debtor has no right to jury trial in adversary proceeding)). The Court has explained above why all of CBI's claims are integrally related to the allowance of Ernst & Young's Proof of Claim, and will not repeat that explanation here. The Court thus finds that the legal issues relevant to CBI's claims have been "converted to * * * issue[s] of equity" and that Ernst & Young therefore is not entitled to a jury trial on those issues. See *Billing* v. *Ravin, Greenberg & Zackin, P.A.*, 22 F.3d 1242, 1253 (3d Cir. 1994) ("allegation of legal malpractice raised as a defense to post-petition fees for bankruptcy counsel * * * falls within the process of the allowance and disallowance of claims * * * [and] debtors have no Seventh Amendment right to trial by jury); *In re Leslie Faye Cos.*, 1997 U.S. Dist. LEXIS 13431, 1997 WL 555607, at *2 (adversary proceeding instituted by debtor is essentially an objection to the allowance of creditors' claims which also seeks affirmative relief, thus creditors have no right to a jury trial of adversary proceeding).[10]

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[10] Ernst & Young also argues that the Seventh Amendment must apply to CBI's claims because (1) those claims seek affirmative relief far in excess of Ernst & Young's Proof of Claim, and (2) Ernst & Young could not possibly have foreseen that it would relinquish its right to a jury trial by filing the Proof of Claim. The Court rejects these arguments. The determination of whether a party is protected by the Seventh Amendment turns neither on the scope of potential damages nor on a party's willful surrender of its Seventh Amendment right; rather, that determination turns on whether the party's claim is integrally related to the claims allowance process. See *Granfinanciera*, 492 U.S. at 60, n. 14 ("once a creditor has filed a claim against the estate, the bankruptcy trustee may recover the full amount of any preference received by the creditor-claimant, even if that

2. Ernst & Young Does Have a Right to a Jury Trial on TCW's Claims

In contrast to CBI's claims, TCW's claims do not "bear[] directly on the allowance of [Ernst & Young's] claims." *Germain*, 988 F.2d at 1329. TCW's claims are for money damages for the alleged, separate and distinct injury sustained by TCW as a creditor of CBI. These claims are not "integrally related" to Ernst & Young's Proof of Claim because that Proof of Claim is against Debtors' bankruptcy estate, not against TCW as a creditor. Even though success on TCW's claims may augment the size of the bankruptcy estate, it will not affect BSI's ability to defend against Ernst & Young's Proof of Claim. See *Germain*, 988 F.2d at 1327 ("If [the bankruptcy trustee] wins, the estate is enlarged, and this may affect the *amount* the [creditor] and its fellow creditors ultimately recover on their claims but it has no effect whatever on the *allowance* of [the creditor's] claims") (emphasis in original). BSI cites to no decision, and the Court has found none, in which a creditor that has filed a proof of claim against the estate is denied the right to a jury trial on the claims of a third party creditor. Unlike the claims asserted by a trustee or other party standing in a debtor's shoes, see, *e.g.*, *Langenkamp*, 498 U.S. 42, *Granfinanciera*, 492 U.S. 33, and *Germain*, 988 F.2d 1323, TCW's claims simply do not affect the allowance of Ernst & Young's Proof of Claim. Accordingly, Ernst & Young has a Seventh Amendment right to a jury trial on the claims assigned by TCW in its role as a creditor. It is of no consequence in determining whether Ernst & Young forfeited its right to a jury trial on TCW's

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amount exceeds the amount of the creditor's claim"); *Germain*, 988 F.2d at 1329.

claims that Ernst & Young forfeited its right to a jury trial on CBI's claims. Cf. *Kerusa Co. LLC* v. *W10Z/515 Real Estate Ltd. P'Ship*, 2004 U.S. Dist. LEXIS 8168, Nos. 04 Civ. 708 (GEL), 04 Civ. 709 (GEL), 04 Civ. 710 (GEL), 2004 WL 1048239, at *6 (S.D.N.Y. May 7, 2004) (although plaintiffs may have jeopardized their right to a jury trial against a bankrupt defendant by filing proofs of claim against the bankrupt's estate, plaintiffs' right to a jury trial on their claims against other defendants against whom they had not filed proofs of claim is unaffected).

The Court has already determined, in the 1999 Order, that the bankruptcy court has the power to conduct a jury trial. Although a remand for a jury trial on TCW's claims may "impede swift resolution of bankruptcy proceedings and increase the expense of Chapter 11 reorganizations," the Court finds that "'these considerations are insufficient to overcome the clear command of the Seventh Amendment.'" *Granfinanciera*, 492 U.S. at 63 (citing *Curtis* v. *Loether*, 415 U.S. 189, 198 (1974)).

Nevertheless, because Ernst & Young argues that it is entitled to judgment against both CBI and TCW on various other grounds, which would negate the need for a new trial on any claims protected by the Seventh Amendment, the Court turns to Ernst & Young's other arguments before deciding whether to remand some, or all, of the claims against Ernst & Young for a jury trial.

C. BSI's Standing

1. Standing to Assert CBI's Claims

BSI asserts claims for fraud, negligence, and breach of contract, as assignee of the claims of the company (*i.e.*, the shareholders).

Ernst & Young appeals the bankruptcy court's decision not to impute the wrongdoing on the part of CBI's management to CBI. Ernst & Young raises the issue of imputation as part of an *in pari delicto* defense. However, because this issue also affects the determination of BSI's standing to assert CBI's claims, the Court considers imputation, as a threshold matter, in terms of standing. See *Steel Co.* v. *Citizens for a Better Environment*, 523 U.S. 83, 94-102 (1998) (explaining that an Article III court cannot decide the meaning or constitutionality of a state or federal law if the plaintiff does not have standing); see also *Wechsler* v. *Squadron, Ellenoff, Plesent & Sheinfeld, L.L.P.*, 212 B.R. 34, 36 n.1 (S.D.N.Y. 1997); *In re Mrs. Weinberg's Kosher Foods, Inc.*, 278 B.R. 358, No. 96 B 44620 (SMB), 2002 WL 1050213, *3 (Bankr. S.D.N.Y. May 28, 2002) ("Some courts view *in pari delicto* as a question of standing, while others treat it as an equitable defense.") (citations omitted). "In essence the question of standing is whether the litigant is entitled to have the court decide the merits of the dispute or of particular issues." *Warth* v. *Seldin*, 422 U.S. 490, 498 (1975). Accord *Shearson Lehman Hutton, Inc.* v. *Wagoner*, 944 F.2d 114, 117 (2d Cir. 1991). A party that does not have standing lacks a "personal stake in the outcome of the controversy" and thus fails to meet the case or controversy requirement of Article III of the Constitution. *Baker* v. *Carr*, 369 U.S. 186, 204 (1962).

The Bankruptcy Code places a trustee in the shoes of the bankruptcy estate. Thus, a trustee has standing to bring any suit that the bankrupt corporation could have brought had the corporation not filed a petition for bankruptcy. See 11 U.S.C. §§ 541 & 542; *Breeden* v. *Kirkpatrick & Lockhart LLP* (*In re Bennett Funding Group, Inc.*), 336 F.3d 94, 99-100

(2d Cir. 2003) (citing *Wagoner*, 944 F.2d at 118). In this appeal, BSI is not a bankruptcy trustee, but it is in a position analogous to the position of a trustee. Both BSI and the typical trustee sue in the shoes of the bankrupt's estate. Thus, by analogy, BSI has standing to institute any suit that Debtors could have instituted had they not filed a petition for bankruptcy. See *Wight* v. *BankAmerica Corp.*, 219 F.3d 79, 80 (2d Cir. 2000) (analogizing the position of the trustee to that of a party suing on behalf of the debtor); *Mediators, Inc.* v. *Manney* (*In re Mediators, Inc.*), 105 F.3d 822, 826 (2d Cir. 1997) (same).

Whether BSI has standing to assert CBI's claims in contract, negligence or tort, or whether the right to sue on those claims belongs to Debtors' creditors, is determined by state law. See *id.* at 825. In its April 5, 2000 decision, the bankruptcy court discussed BSI's standing to raise CBI's claims without distinguishing the nature of claims. See *In re CBI Holding*, 247 B.R. at 364-65. The Court here considers BSI's standing to assert, first, CBI's claims for fraud, second, CBI's claims for negligence, and, third, CBI's claim for breach of contract.

a. CBI's Fraud Claims

CBI's fraud claims against Ernst & Young relate to Ernst & Young's (1) fraud and/or recklessness in conducting the fiscal 1992 and 1993 audits, and (2) fraud and/or recklessness in inducing CBI to retain Ernst & Young to perform the reaudit. There is no dispute among the parties that members of CBI's management knew of, purposely did not record, and sought to conceal from Ernst & Young, certain of CBI's liabilities. See, *e.g.*, RE 107-12, 983 & 1253-54.

In *Wagoner*, the Second Circuit declared that a "claim against a third party for defrauding a corporation with the cooperation of management accrues to creditors, not to the guilty corporation." *Wagoner*, 944 F.2d at 120. Accord *Wight*, 219 F.3d at 86; *In re Mediators, Inc.*, 105 F.3d at 826; *Hirsch* v. *Arthur Andersen & Co.*, 72 F.3d 1085, 1094 (2d Cir. 1995). Thus, a bankruptcy trustee, and anyone who similarly stands in the shoes of the bankrupt corporation, generally does not have standing to raise those claims. See *In re Bennett Funding Group, Inc.*, 336 F.3d at 99-100.

This rule, which has come to be known as the "*Wagoner* rule," is derived from fundamental principles of agency law. The law of agency relies on certain presumptions that regulate the responsibility of a principal for the acts of his agent. The law of agency presumes that when an agent acquires knowledge while acting within the scope of his agency, that knowledge will generally be disclosed to his principal. See *Munroe* v. *Harriman*, 85 F.2d 493, 495 (2d Cir. 1936) ("The presumption of communication [of the agent's knowledge] is a pure fiction, contrary to the fact, for it is only when the agent has failed to communicate his knowledge that any occasion arises for imputing it to the principal."). The presumption that an agent communicates such knowledge results from an attempt to balance factors that favor imputing an agent's knowledge to his principal (*i.e.*, the principal has control over the agent, the principal should be incentived to monitor the agent, and the principal chooses to use an agent as his link to the outside world) and factors that disfavor imputing the agent's knowledge to his principal (*i.e.*, agency would fall into desuetude if imputation had no bounds).

It is undisputed that various members of CBI management, including Castello, committed acts of fraud that were not discovered by Ernst & Young during its fiscal 1992 and 1993 audits. If the acts of those individuals, and the knowledge of the fraud possessed by those individuals, can be imputed to CBI itself, CBI (and, hence, BSI, insofar as BSI stands in CBI's shoes) lacks standing to sue Ernst & Young for aiding and abetting the fraud. The acts of fraud will be imputed under the Wagoner rule, and principles of agency law, unless some exception to the rule applies.[11]

i. The "Adverse Interest" Exception

Courts have long recognized an "adverse interest" exception to the *Wagoner* rule (the *Wagoner* rule, as stated above, presumes that an agent's knowledge will be communicated to his principal, and thus imputes the agent's knowledge to the principal). The "adverse interest" exception to *Wagoner's* rule of imputation provides that when an agent is "committing a fraud for his own benefit," and has "totally abandoned" his principal's interest, the acts of the agent will not be imputed to the principal, and

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[11] BSI asserts that Ernst & Young aided and abetted the fraud perpetrated by management in that Ernst & Young knowingly and/or recklessly prepared CBI's audits. The distinction between a claim for fraud arising out of a third party's alleged cooperation with management, and a claim for fraud arising out of a third party's alleged aiding and abetting management, is immaterial for purposes of application of the *Wagoner* rule. See *Hirsch*, 72 F.3d at 1094 (bankruptcy trustee lacks standing to sue third party for *cooperating with* management in perpetrating the Ponzi scheme); Wagoner, 944 F.2d at 119-20 bankruptcy trustee lacks standing to sue third party for *aiding and abetting* the scheme of the president and sole shareholder).

the claim against a third party for defrauding the corporation will remain with the corporation, and not be transferred to the creditors. *In re Bennett Funding Group, Inc.*, 336 F.3d at 100 (citing *Wight*, 219 F.3d at 87). The adverse interest exception is a narrow one; for it to apply, "the agent must have totally abandoned his principal's interests and be acting entirely for his own or another's purposes." *Center* v. *Hampton Affiliates, Inc.*, 66 N.Y.2d 782, 784-85, 488 N. Ed. 2d 828, 497 N.Y.S.2d 898 (1985). Accord *In re Bennett Funding Group, Inc.*, 336 F.3d at 100 (citing *In re Mediators, Inc.*, 105 F.3d at 827).

The adverse interest exception is entirely consistent with the principles of agency law explained above. Normally, courts will impute the knowledge of an agent acting within the scope of his agency to his principal, because courts presume that such an agent communicates that knowledge to his principal. The practice of *presuming* the transfer of knowledge, and thus *imputing* the agent's knowledge to the principal, is a fiction necessitated by the compromise addressed above. That fiction is untenable, however, when an agent has *totally abandoned* the interests of his principal, and acted *entirely* in his own or a third party's interest, because an agent "cannot be presumed to have disclosed that which would expose and defeat his fraudulent purpose." *Center*, 66 N.Y.2d at 784.

The bankruptcy court's decision states a number of times that the segment of management involved in the fraud was acting in its own interest and not acting in CBI's interest. The bankruptcy court stated, specifically, that the purpose of the fraud was to obtain a bigger bonus for Castello, and to preserve Castello's personal control over CBI. See *In re CBI Hold-*

ing, 247 B.R. at 365. These statements (made among the bankruptcy court's findings of law) support the bankruptcy court's conclusion that the adverse interest exception applies, and that imputation is therefore inappropriate. However, in its findings of fact, the bankruptcy court suggested (perhaps inadvertently) that there existed at least one purpose for the fraud other than to obtain a bigger bonus for Castello, and to preserve Castello's personal control over CBI: The bankruptcy court stated in its findings of fact that "[a] *principle* [sic] reason why * * * members of management caused liabilities to remain unrecorded at year-end was *not for any corporate purpose* but rather to ensure that Castello received the maximum bonus and remained in control." *Id.* at 360 (emphases added). This language leaves open the possibility that the bankruptcy court found that some corporate purpose was served by the fraud. If the Court determines that it is necessary and appropriate to remand the action to the bankruptcy court for further proceedings related to CBI's claims, the bankruptcy court should clarify whether *any* corporate purpose was served by the fraud, or whether the corporation's interests were "totally abandoned" by managers acting "entirely" for their own or another's interest. *Center*, 66 N.Y.2d at 785. Accord *Wight*, 219 F.3d at 87; *In re Mediators, Inc.*, 105 F.3d at 827.

The Court notes that whether managers have acted entirely in their own interests can be difficult to determine in the corporate setting, where a manager's fortune may depend upon the corporation's short-term fortune, and thus the manager may fraudulently manipulate corporate affairs in a way that causes short-term benefits to accrue to the corporation, for the sole purpose of receiving higher remuneration himself. Moreover, the Court is not con-

vinced that the purpose behind management's conduct should be dispositive of the issue.[12] Neverthe-

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[12] In *Cenco Inc.* v. *Seidman & Seidman*, Judge Posner analyzed both the difficulties in assessing a manager's motives, and the broader question of whether those motives should be dispositive of any claim brought by a company whose managers contributed in defrauding the company. See *Cenco Inc.* v. *Seidman & Seidman*, 686 F.2d 449, 453-57 (7th Cir. 1982). In *Cenco*, management accomplished both self-aggrandizement and corporate-aggrandizement by inflating inventories far above value, which caused a rise in the company's stock price, and enabled the company to borrow at lower rates, and to recover inflated insurance proceeds. Analyzing that scenario under Illinois law, the *Cenco* Court found that the question of whether the corporation had a cause of action turned on whether the wrongdoers were acting on behalf of the corporation, and that that determination was for the finder of fact.

However, the *Cenco* Court appears to have attempted to refine the law to more closely reflect corporate realities; in order to determine whether acts of fraud committed by management should be imputed to the company when the fraud benefits both the managers and the company, and harms only outsiders, the court did not focus on the intent of the managers who were committing the fraud (*i.e.*, whether the managers had totally abandoned the company's interest, and were acting entirely on their own behalf, unconcerned that their acts of fraud had the effect of simultaneously benefitting the company). Rather, Judge Posner considered the traditional objectives of tort liability, which are to compensate victims and deter future wrongdoing. See *id.* at 455. Judge Posner pointed out that a corporation is merely a legal fiction, and that, if a corporation recovers as a victim of an auditor's "laxity," it is the stockholders as of the date of judgment who will benefit from any judgment. However, as explained by Judge Posner, it is unfair for those stockholders to recover if they include: the corrupt officers themselves; the stockholders who were responsible for the lax corporate management (by electing a lax board of directors); or the stockholders who bought after the fraud was un-masked, and who, therefore, lost nothing. *Cenco* suggests that courts should focus on who bore the "primary costs" of the fraud--stockholders, or out-

less, the Court is bound by New York law as described above.

ii. The So-Called Innocent Insider Exception

The bankruptcy court's decision to apply the adverse interest exception to CBI's claims was not its primary justification for declining to impute management's fraudulent conduct to the company. The primary justification was that at least one decision-maker among CBI's stockholders (*i.e.*, TCW), and at least one decision-maker on CBI's board of directors (*i.e.*, Frank Pados), were innocent of the fraud, and either would have taken steps to stop the fraud had the fraud been known. See *In re CBI Holding*, 247 B.R. at 365.

In reaching this conclusion, the bankruptcy court appears to have found applicable a second exception to the *Wagoner* rule (*i.e.*, an exception to a presumption of imputation), separate and apart from the adverse interest exception discussed above. Some courts have recognized this second exception, and have referred to it as the "innocent insider" exception. See *Wechsler*, 212 B.R. at 36 (Knapp, J.);

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siders to the corporation—rather than on the purpose behind the fraud.

The *Cenco* Court did not choose among the various tests that it articulated (*e.g.*, whether wrongdoers were acting on behalf of the corporation; who bore the costs of the wrongdoing; how to deter future wrongdoing), because, under the facts presented, all of the tests for non-recovery were satisfied: the jury (probably) had found that the managers had been acting on Cenco's behalf, even though managers were "aggrandized" by the fraud, and even though there were some innocent managers and directors; the primary costs of the fraud were borne by outsiders to the corporation, not by stockholders; and it would be "perverse" to allow either corrupt, lax or uninjured stockholders to recover.

Breeden v. *Kirkpatrick & Lockhart, LLP*, 268 B.R. 704, 710 (S.D.N.Y. 2001) (Sprizzo, J.); *Securities Investor Protection Corp.* v. *BDO Seidman, LLP*, 49 F. Supp. 2d 644, 650-51 (Preska, J.); *Lippe* v. *Bairnco Corp.*, 218 B.R. 294, 302 (S.D.N.Y. 1998) (Chin, J.).[13] The innocent insider exception, as explained by some courts, and as addressed by the bankruptcy court below, focuses not on whether culpable managers totally abandoned the company's interest, but rather on whether some part of management was innocent of the misconduct, unaware of it, and able to prevent it had the misconduct been known.

The Second Circuit recently discussed the "innocent insider" exception, but decided not to resolve "the question of whether the presence of innocent directors would provide the trustee with standing where fewer than all shareholders are implicated in the fraud." *In re Bennett Funding Group, Inc.*, 336 F.3d at 101. Instead, the court assumed, *arguendo*, that such an exception exists, but concluded that the prerequisites for its application were absent in the case, because the innocent insiders there were so impotent that they would have been unable to stop the fraud even if they had been aware of it. *Id.*

The rationale behind the innocent insider exception appears to be that, where only some members of management are guilty of the misconduct, and the innocent members could and would have prevented

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[13] The innocent insider exception was first articulated by Judge Knapp in the context of a motion to dismiss. See *Wechsler*, 212 B.R. 34. The Court addresses the exception here because the dicta of a number of other decisions suggest that the exception might extend beyond that context. See *Breeden*, 268 B.R. at 710; *BDO Seidman*, 49 F. Supp. 2d at 650-51; *Lippe*, 218 B.R. at 302.

the misconduct had they known of it, the culpability of the malefactors should not be imputed to the company because that imputation would punish innocent insiders (*e.g.*, non-culpable shareholders) unfairly.

This reasoning was rejected by the Seventh Circuit in *Cenco*, which stated that where a publicly traded company has delegated to a board of directors the owners' role of hiring and supervising managers, and where that board has failed to prevent managers from committing fraud, the managers' misconduct should be imputed to the company, so as not to disincentivize the innocent managers, board members, and owners from policing the conduct of the guilty. *Cenco*, 686 F.2d at 454-56. Accord Restatement (Third) Agency § 5.03 cmt. b (2002) ("Imputation creates incentives for a principal to choose agents carefully and to use care in delegating functions to them."). The Court agrees with *Cenco's* reasoning, and concludes that misconduct by those given authority to make decisions on behalf of a company should be imputed to the company even if innocent members of management could and would have prevented the fraud had they been aware of it. The Court, therefore, declines to adopt any innocent insider exception to the *Wagoner* rule.[14]

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[14] The Court's decision not to adopt an innocent insider exception to the *Wagoner* rule is supported by New York law, which provides only a very narrow exception to the general rule that an agent's knowledge and conduct is imputed to his principal. As already explained, that exception applies if: (1) the culpable agent totally abandons his principal's interests; and (2) the culpable agent(s) are not the sole shareholder(s) (in which case, the agent and the principal are one). *Center*, 66 N.Y.2d at 784-85.

iii. The Sole Actor Rule and the Innocent Insider Exception

Although the Court rejects the innocent insider exception, the Court nonetheless takes this opportunity to address what appears to be substantial confusion evidenced by several courts, including the bankruptcy court below, regarding the nature of the so-called "innocent insider" exception.

As the Court explained above, the bankruptcy court's decision in this case to not impute management's misconduct to the company due to the presence of innocent insiders was made entirely separately from the bankruptcy court's consideration of the "adverse interest" exception to the *Wagoner* rule. That is, first the bankruptcy court declined to impute management's misconduct due to the existence of innocent insiders. Then, the bankruptcy court stated that even if management's wrongdoing should be imputed to the company, CBI would nonetheless have standing because the "adverse interest exception" would apply, given management's apparent total abandonment of the company's interests. See *In re CBI Holding*, 247 B.R. at 365. The Court disagrees with the bankruptcy court's analysis of the interaction between the *Wagoner* rule, the adverse interest exception, and the so-called innocent insider exception.

The key flaw in the analysis is that the primary question to be addressed when considering the fiction of imputation is whether the knowledge of the agent that is to be imputed to the principal was gained within, or outside of, the scope of agency. Even when an agent is defrauding his principal, unless the agent has totally abandoned the interests of the principal and is acting entirely in his own, or another person's,

interest, that agent is acting within the scope of his agency. Thus, unless the adverse interest exception to the presumption of imputation applies, it is immaterial whether innocent insiders exists; the agent is still acting on behalf of the company, and his actions will be imputed to the company notwithstanding the existence of those innocent insiders.

When an agent has acted outside of the scope of his agency, however, his acts will nevertheless be imputed to the principal "where the principal and agent are one and the same." *In re Bennett Funding Group, Inc.*, 336 F.3d at 100 (citation and quotation marks omitted). This exception to the adverse interest exception, styled the "sole actor rule," operates most clearly in the context of a corporation owned and managed by a single person. When that person, in his role as a manager, defrauds the corporation in order to benefit only himself, he has acted outside of the scope of his agency; technically, the agent's fraudulent actions should not be imputed to the company pursuant to the "adverse interest" exception. However, it would be nonsensical to refrain from imputing the agent's acts of fraud to the corporation, despite the agent's total abandonment of the corporation's interests, because the agent is identical to the corporation. See *In re Mediators, Inc.*, 105 F.3d at 827. The same analysis would apply to a corporation owned and managed by multiple people, so long as all of them were involved together in a fraud against the corporation.

Where only some of a corporation's owners were involved in a fraud in their role as managers, courts consider whether those insiders who were innocent and unaware of the misconduct had sufficient authority to stop the fraud. See, *e.g.*, *In re Bennett*

Funding Group, Inc., 336 F.3d at 101 (innocent director was "impotent to actually do anything"); *Munroe*, 85 F.2d at 495-96 (innocent members of a bank loan committee were dominated by fraudulent committee member). Cf. *Wechsler*, 212 B.R. at 36 ("the *Wagoner* rule only applies where *all relevant* shareholders and/or decisionmakers are involved in the fraud") (emphasis added to the word "relevant"). When the innocent insiders lack authority to stop the fraud, the "sole actor" exception to the "adverse interest" exception applies, and imputation is thus proper, because all *relevant* shareholders and decision-makers were involved in the fraud. However, when the innocent insiders possessed authority to stop the fraud, the "sole actor rule" does not apply, because the culpable agents who had totally abandoned the interests of the principal, and were thus acting outside of the scope of their agency, were not identical to the principal.

b. CBI's Negligence Claims

CBI's negligence claims against Ernst & Young relate to Ernst & Young's (1) negligence in connection with the fiscal 1992 and 1993 audits, and (2) negligent misrepresentation that the fiscal 1992 and 1993 audits were materially accurate, and were conducted in compliance with GAAS.

The *Wagoner* rule does not necessarily govern CBI's negligence claims, because the right to sue for fraud and the right to sue for negligence inhere in different entities. As already explained, under New York law as stated in the *Wagoner* rule, where a third party defrauded the corporation with the cooperation of management, the right to sue the third party for fraud generally accrues to the creditors, not to the corporation itself. By contrast, where a third

party has committed negligence, the right to sue the third party for that negligence accrues to the corporation itself. See, *e.g.*, *Sec. Investor Prot. Corp.* v. *BDO Seidman, LLP*, 95 N.Y.2d 702, 711-12, 746 N.E.2d 1042, 723 N.Y.S.2d 750 (2001); *Credit Alliance Corp.* v. *Arthur Andersen & Co.*, 65 N.Y.2d 536, 551, 483 N.E.2d 110, 493 N.Y.S.2d 435 (1985). Indeed, under New York law, a negligence claim against an accountant belongs *only* to the corporation-client, except where there is sufficient privity between the accountant and a third party, non-client (e.g., a creditor of the client). *Id.* (setting forth standard for cause of action by third party against accountant). Accordingly, the right to sue Ernst & Young for any negligence belonged to CBI and to any third party creditor with sufficient privity to Ernst & Young.

The question arises whether CBI's committing the fraud strips it of standing to sue Ernst & Young for negligence. There is some support for the proposition that CBI lacks standing to sue Ernst & Young for its negligence, due to CBI's own fraudulent actions. For example, in *Cenco*, Judge Posner reasoned that "breach of contract, negligence, and fraud, when committed by auditors, are a single form of wrongdoing under different names." *Cenco*, 686 F.2d at 453. Based on that reasoning, Judge Posner found that a company that lacked standing to sue its accountant for fraud (on the ground that the company itself was involved in the fraud) also lacked standing to sue its accountant for negligence.

The Second Circuit has adopted a more expansive view than that articulated in *Cenco* of the circumstances in which a company has standing: A bankruptcy trustee has standing to assert claims

other than fraud claims against a third party where the facts giving rise to those claims are distinct from any facts concerning any participation by the third party in management's fraud. That standard is supported by the logic underlying both *Wagoner*, 944 F.2d 114, and *Hirsch*, 72 F.3d 1085. In *Wagoner*, the Second Circuit found that, although the bankruptcy trustee could not sue the company's broker for fraud, the trustee could sue the company's broker in contract for churning the company's account. *Wagoner*, 944 F.2d at 119. *Wagoner's* finding was based on the fact that churning may form the basis for a cause of action in contract, and that the broker's alleged churning was "clearly distinct" from the broker's alleged participation in management's fraud. See *Hirsch*, 72 F.3d at 1094 n.6 (discussing *Wagoner's* finding that the trustee had standing on the churning claim). Accord *Wagoner*, 944 F.2d at 119. By way of contrast, in *Hirsch*, the allegations giving rise to the malpractice claim (which was not based in fraud) were "closely tied" to the allegation that defendants had participated in management's fraud. *Hirsch*, 72 F.3d at 1089-90 & 1094 n.6. Thus, the *Hirsch* court held that the trustee lacked standing to bring the malpractice claim on behalf of the company against the defendant accountants and law firms.[15] See also *In re Bennett Funding Group, Inc.*, 336 F.3d at 100 (applying the *Wagoner* rule to bar the trustee's pro-

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[15] Significantly, by ruling that the trustee lacked standing to sue the defendant accountants and law firms for malpractice, the *Hirsch* panel did not absolve those defendants of liability. *Hirsch* was decided under Connecticut law, which, unlike New York law, allows a non-client to sue a professional for malpractice, without regard to whether that non-client is in privity with the professional. *Hirsch*, 72 F.3d at 1093.

fessional malpractice claims, where the third-party professionals were allegedly complicit in the fraud). Even so, the *Hirsch* court recognized that if the trustee could establish "some independent financial injury to the [debtor company] * * * as a result of the alleged professional malpractice," the trustee could have standing to sue a third party on a claim other than fraud, even where the trustee lacked standing to sue for fraud. *Hirsch*, 72 F.3d at 1094.

Applying that standard here, the Court finds that the allegations giving rise to CBI's claims premised on negligence are clearly distinct from the allegations premised on management's fraud. BSI here does not allege that Ernst & Young participated in the fraud perpetrated by CBI's culpable officials. Indeed, BSI does not dispute that those officials attempted to conceal the fraud from Ernst & Young. Rather, BSI alleges that Ernst & Young is independently at fault for committing errors in auditing CBI. According to BSI's negligence claims, a reasonable accountant would not have made the auditing errors that Ernst & Young made, even if the culpable CBI officials had tried to hide their fraud from that (reasonable) accountant. BSI thus has asserted that CBI was injured (in a legally cognizable way) by Ernst & Young's performance of the audits. Accordingly, BSI has standing to assert CBI's claims for negligence.[16]

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[16] Although the Court's conclusion (that BSI has standing to assert CBI's claims for negligence) is different from the conclusion reached by the Seventh Circuit in *Cenco*, the Court's conclusion nevertheless achieves the objectives underlying tort liability, articulated in *Cenco*. In *Cenco*, Judge Posner explained those objectives as two-fold: "to compensate the victims of wrongdoing and to deter future wrongdoing." *Cenco*, 686 F.2d at 455. Holding Ernst & Young liable for any wrongdoing to CBI both com-

The Court's conclusion that BSI has standing to assert CBI's negligence claims (despite the fact that CBI contributed to its own injuries) is consistent with New York law. New York law employs a comparative negligence analysis, in which a plaintiff's contributory fault (*e.g.*, CBI's fraud) does not bar the plaintiff's recovery against a defendant who caused some of the plaintiff's injuries. N.Y. C.P.L.R. § 1411; 1A Pattern Jury Instructions 2:36 intro. stmt. (3d ed. 2004). Rather, under New York's scheme, the recovery accorded to a plaintiff that is partially at fault for its own injuries may be diminished in proportion to the plaintiff's fault. See *id.*; 1B Pattern Jury Instructions 2:154 cmt. (3d ed. 2004). See also *Hall & Co.* v. *Steiner & Mondore*, 147 A.D.2d 225, 227-28, 543 N.Y.S.2d 190 (N.Y. App. Div. 1989) (plaintiff alleging accountant malpractice for accountant's failure to discover irregularities purposely made in plaintiff's books is subject to accountant-defendant's affirmative defense of culpable or negligent conduct); *Craig* v. *Anyon*, 212 A.D. 55, 208 N.Y.S. 259 (N.Y. App. Div. 1925) (same). Thus, under New York law, the fault *imputed* to CBI as a result of management's fraud does not bar CBI's claims for negligence, and BSI has standing to assert those claims on behalf of CBI.[17]

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pensates CBI for any injury caused therefrom and deters accountants from performing negligent audits. Indeed, if BSI did not have standing to assert CBI's negligence claims, then any negligence on the part of Ernst & Young would go unpunished, and auditors would not be deterred from performing negligent audits, unless creditors with sufficient privity to the auditors could be found.

[17] The Court recognizes that other decisions in this district have applied the *Wagoner* rule to preclude a trustee from asserting negligence claims in the context of corporate fraud. See

c. CBI's Contract Claims

There can be no question that, if CBI's management had not defrauded the company, New York law would accord CBI the right to sue Ernst & Young for the alleged breach of contract. The allegations giving rise to the claims for contractual breach are analogous to the allegations giving rise to the claims for negligence. Based on the logic articulated above with respect to the negligence claims, the Court finds that BSI has standing to assert CBI's claims for breach of contract.

2. Standing to Assert TCW's Claims

In addition to asserting the above claims on TCW's behalf as a shareholder of CBI, BSI asserts claims for fraud and negligence as assignee of TCW's claims made in TCW's capacity as creditor. As explained above, "a claim against a third party for defrauding a corporation with the cooperation of management accrues to creditors * * *." *Wagoner*, 944 F.2d at 120. Accordingly, TCW, as a creditor of CBI, has standing to assert fraud claims against Ernst & Young.

With respect to TCW's claims for negligence, under New York law, an accountant generally cannot be held liable to third parties for the negligent performance of an auditing contract between the accountant and his client. See *Security Pac. Bus. Credit, Inc.* v. *Peat Marwick Main & Co.*, 79 N.Y.2d

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Breeden, 268 B.R. at 709; *Brown* v. *Deloitte & Touche, LLP*, 1999 U.S. Dist. LEXIS 6279, 1999 WL 269901, *2 (S.D.N.Y. May 4, 1999); *Wechsler*, 212 B.R. at 36. Those decisions are distinguishable from the instant action on their facts, and the Court respectfully declines to apply to the facts before it any principles adopted in those decisions.

695, 597 N.E.2d 1080, 586 N.Y.S.2d 87 (1992); *Credit Alliance Corp.* v. *Arthur Andersen & Co.*, 65 N.Y.2d 536, 483 N.E.2d 110, 493 N.Y.S.2d 435 (1985). However, a negligent accountant can be held liable to a third party if: (1) the accountant was aware that his financial reports were to be used for a particular purpose; (2) a known third party was intended to rely on the financial reports in furtherance of that purpose; and (3) some conduct on the part of the accountant links the accountant to the third party and shows that the accountant understood that the third party relied on the accountant. *Id.* at 551. These "indicia, while distinct, are interrelated and collectively require a third party claiming harm to demonstrate a relationship or bond with the once-removed accountants * * *." *Security Pacific*, 79 N.Y.2d at 702-03.

Applying this test (the "*Credit Alliance* test"), the bankruptcy court here concluded that the relationship between Ernst & Young and TCW sufficiently approached actual privity for TCW to have a claim against Ernst & Young. *In re CBI Holding*, 247 B.R. at 365-66. Given that the Court has concluded that Ernst & Young has a right to a jury trial with respect to TCW's claims, the disputed facts pertaining to the *Credit Alliance* test must be put before a jury.[18] 18

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[18] The law is unclear as to whether the Court should address TCW's negligence claims as a matter of standing or as failure to state a claim. Contrast, *e.g.*, *Hirsch*, 72 F.3d at 1093 (referring to standing under Connecticut law), with *BDO Seidman*, 49 F. Supp. 2d at 654 (considering the issue under the jurisprudence for failure to state a claim). This distinction is immaterial in the instant appeal and the Court, therefore, does not consider it. If, on remand, the bankruptcy court concludes that this question is properly considered as a matter of standing, the bankruptcy

The Court thus reverses the bankruptcy's court's determination that BSI possessed standing to assert TCW's negligence claims.

D. Affirmative Defense (against TCW's claims)

Ernst & Young contends that BSI is precluded from asserting TCW's claims under New York's General Obligations Law, which provides that "[a] tortfeasor who has obtained his own release from liability shall not be entitled to contribution from any other person." N.Y. Gen. Oblig. L. § 15-108(c). Under the Plan, TCW obtained a release from liability to CBI and to CBI's other creditors for TCW's role, if any, in CBI's demise. See RE 799a (releasing TCW "from any and all claims"). Pointing to that release, Ernst & Young asserts that TCW cannot now seek contribution from Ernst & Young. New York law defines the term "contribution" as a claim that may be made among two or more persons who are "subject to liability for damages for the same * * * injury to property * * *." N.Y. C.P.L.R. § 1401.

The Court finds that TCW's claims against Ernst & Young are not claims for "contribution" because those claims do not arise from the "same injury" as the injuries for which TCW obtained a release. TCW obtained a release from any liability arising out of the injuries to CBI and to CBI's other creditors. TCW does not now seek contribution from Ernst & Young concerning those injuries. Rather, TCW seeks damages for the injuries suffered by TCW itself. TCW's injuries are factually related to the injuries suffered by CBI and by CBI's other creditors, but TCW's injuries, nevertheless, are separate and distinct. See,

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court can make a determination of whether the jury needs to decide any jurisdictional facts pertaining to standing.

e.g., *Cresswell* v. *Warden*, 164 A.D.2d 855, 856, 559 N.Y.S.2d 361 (N.Y. App. Div. 1990) ("It is the fact of liability to the same person for the same harm * * * which controls.") Accordingly, Ernst & Young's defense against TCW under New York's General Obligations Law, § 15-108(c), is misguided. See, *e.g.*, *Nassau Roofing & Sheet Metal Co.* v. *Facilities Dev't Corp.*, 71 N.Y.2d 599, 604, 523 N.E.2d 803, 528 N.Y.S.2d 516 (1988) (no claim for contribution where injuries are separate and distinct).

IV. Conclusion

For the reasons stated above, the Court reiterates its previous holding that all of the claims in this action are core, and further concludes: (1) that Ernst & Young has a right to a jury trial on TCW's claims as a creditor; (2) that BSI has standing to sue Ernst & Young for negligence and breach of contract on behalf of CBI, and for fraud on behalf of TCW as a creditor; and (3) that TCW is not precluded from suing Ernst & Young under N.Y. Gen. Oblig. L. 15-108. The Court therefore vacates the judgment of the bankruptcy court with respect to the claims asserted by BSI on behalf of TCW in its role as a creditor.

The Court does not now resolve whether BSI has standing to sue Ernst & Young for fraud on behalf of CBI, or negligence on behalf of TCW as a creditor. Nor does the Court now resolve the other issues raised on appeal, some of which are rendered moot by the Court's conclusion that Ernst & Young is entitled to a jury trial with respect to TCW's claims.

The Court orders the parties to submit a proposed briefing schedule to address the question of whether the Court's conclusion that Ernst & Young is entitled to a jury trial with respect to TCW's

claims necessitates a new trial on CBI's claims as well. The Court notes that the only briefing on this subject to date is contained in a single paragraph in Ernst & Young's reply brief. See Reply Brief of Appellants Ernst & Young, Ernst & Young LLP, at 5.

SO ORDERED.

APPENDIX D

[Opinion of the United States District Court For the Southern District of New York (August 13, 1999)]

United States District Court, Southern District of New York

In re CBI HOLDING COMPANY, INC., et al., Debtors,

Bankruptcy Services, Inc., Plaintiff.

v.

Ernst & Young and Ernst & Young, LLP, Defendants,

Case No. 94-B-43819 (BRL).

Adv. Proc. No. 96-9143A

96 CIV 7969 (KMW)

August 13, 1999.

WOOD, U.S.D.J.

Defendants move for reconsideration and reargument of the Court's November 13, 1998 Order denying defendants' motion to: (1) withdraw the reference of this proceeding from the bankruptcy court pursuant to 28 U.S.C. § 157(d); (2) abstain pursuant to 28 U.S.C. § 1334(c); and (3) dismiss the action *sua sponte* for lack of subject matter jurisdiction pursuant to Fed. R. Civ. P. 12(h)(3). For the reasons stated below, the Court reaffirms its previous order and denies defendants' motion for reconsideration.

I. Discussion

1. Legal Standard

The standard is clear on a motion for reargument. "The only proper ground on which a party may move to reargue an unambiguous order is that the court overlooked 'matters or controlling decisions' which, had they been considered, might reasonably have altered the result reached by the court." *Morse/Diesel. Inc.* v. *Fidelity & Deposit Co.*, 768 F. Supp. 115, 116 (S.D.N.Y. 1991) (quoting *Adams* v. *United States*, 686 F. Supp. 417, 418 (S.D.N.Y. 1988) (quoting Local Civil Rule); see also *Schonberger* v. *Serchuk*, 742 F. Supp. 108, 119 (S.D.N.Y. 1990). Courts in this circuit have emphasized that the provision for reargument "is not designed to allow wasteful repetition of argument already briefed, considered and decided." *Morse*, 768 F. Supp. at 116; see also *Ruiz* v. *Comm'r of Dep't of Transp.*, 687 F. Supp. 888, 890 (S.D.N.Y.), *aff'd* 858 F.2d 898 (2d Cir. 1988) ("The standard for granting a motion for reargument is strict in order to dissuade repetitive arguments on issues that have already been considered fully by the Court.") In addition, a party making a motion for reargument may not advance new facts, issues, or arguments not previously presented to the Court. See *Weissman* v. *Fruchtman*, 124 F.R.D. 559, 560 (S.D.N.Y. 1989).

2. Defendants' Arguments Presented in the Motion for Reconsideration

Defendants present no new arguments in support of their motion for reconsideration that were not previously asserted in support of the motion to withdraw the reference. Therefore, the Court need only briefly address defendants' arguments below.

Defendants' principal argument is that this Court erred in denying their motion to withdraw the reference from the bankruptcy court because several of the claims brought by plaintiff Bankruptcy Services, Inc. ("BSI") against defendants were assigned directly to BSI from Trust Company of the West ("TCW"), a major equity holder of CBI, and as such never belonged to CBI or CBI's estate. Defendants assert that these claims constitute claims between two non-debtor third parties (*i.e.*, TCW and defendants), rather than core claims which could be properly heard in the bankruptcy court.

It is well settled that a bankruptcy court does not have jurisdiction to decide controversies between non-debtor third parties, unless the claims involve the debtor or the debtor's property, or the bankruptcy court cannot complete its administrative duties without resolving the controversy. See *In re Shirley Duke Assoc.*, 611 F.2d 15, 17 (2d Cir. 1979). In the instant case, all of the claims asserted by BSI involve CBI, in that BSI is asserting the claims solely as a representative of CBI's estate, and the resolution of these claims will determine the amount of the estate that will be available to administer to CBI's creditors, including defendants who are creditors that have filed a Proof of Claim against CBI.[1] The fact that some of the claims asserted by BSI against defendants were assigned to BSI from a

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[1] Defendants principally rely on Judge Cedarbaum's holding in *In re Liquidators Corp.*, 222 B.R. 209 (S.D.N.Y. 1998) for the proposition that claims asserted by third-parties cannot qualify as core claims under 28 U.S.C. § 157(b). That case is distinguishable because the claims there, unlike here, were brought in an independent suit by shareholders and any recovery would have been distributed to the shareholders.

third-party non-debtor does not alter this Court's earlier finding that those claims are core claims pursuant to 28 U.S.C. § 157(b)(2).

Defendants also challenge the Court's finding that BSI's claims are core pursuant to 28 U.S.C. § 157(b)(2)(C) as "counterclaims by the estate against persons filing claims against the estate." Defendants argue that the Creditors' Committee did not have the authority under the terms of the Plan to object to Proofs of Claim after the confirmation of the Plan, and therefore any assignment of these objections was invalid. The Court looks to the terms of the Plan and the Confirmation Order to determine the extent to which the Creditors' Committee continues to function once the Plan has been confirmed. See *In re Salant Corp.*, 176 B.R. 131, 134 (S.D.N.Y. 1994). In the instant case, the Plan broadly authorizes the Creditors' Committee to, *inter alia*, "exercise all its rights and powers necessary to the implementation of the Plan," and to "execute, enter into, and deliver any documents or instruments necessary and appropriate to effectuate and implement the Plan and to take such other actions and perform such other acts as may be necessary and appropriate to implement and effectuate the Plan." The Court agrees with BSI that the Creditors' Committee assigned the objection in furtherance of the implementation of the Plan, and was therefore acting within the scope of its authority under the Plan. The Court rejects defendants' argument that the Creditors' Committee did not have the authority to assign its objection to defendants' Proof of Claim to BSI after the Plan was confirmed. Defendants present no new argument or evidence to warrant a change in the Court's earlier finding that the Creditors' Committee timely objected to defendants' Proof of Claim, and effectively

assigned to BSI its objection. For the reasons stated above, and for the reasons stated in the Court's November 1998 Order, the Court finds that BSI's claims constitute counterclaims to defendants' Proof of Claim, and therefore qualify as core proceedings pursuant to 28 U.S.C. § 157(b) (2) (C).

Finally, defendants challenge this Court's finding that the interests of judicial economy will be best served if this proceeding remains in the bankruptcy court. In deciding whether to withdraw the reference from the bankruptcy court, the Court considers, among other factors, how long a bankruptcy case has been pending in the bankruptcy court, and whether the action can be most expeditiously and economically resolved in that court. See *In re Kenai Corp.*, 136 B.R. 59, 61 (S.D.N.Y. 1992). As the Court observed in its November 1998 Order, this is a mature proceeding with which Bankruptcy Judge Lifland is very familiar; he has conducted numerous hearings and supervised discovery disputes among the parties since 1994. Bankruptcy Judge Lifland has also warned the parties at several hearings held subsequent to the Court's November 1998 Order that this proceeding must move expeditiously to trial; to that end, Bankruptcy Judge Lifland has set a trial date of September 13, 1999. The Court reaffirms its finding that the interests of judicial economy and efficiency are best served if this proceeding remains in the bankruptcy court.

Having reviewed all of the arguments presented in defendants' motion for reconsideration, the Court finds that they provide no basis for altering the Court's November 1998 order; defendants offer neither controlling law nor overlooked evidence that would have affected the Court's ruling. Thus, for all

the reasons stated in this order, and for the reasons stated in the Court's order of November 1998, the Court finds that this proceeding qualifies as a core proceeding pursuant to 28 U.S.C. § 157(b)(2)(A), (B), (C), and (O).

3. Defendants' Arguments Presented in the Order to Show Cause

Defendants also filed an Order to Show Cause seeking withdrawal of the reference from the bankruptcy court, for the purposes of trial, arguing that they do not consent to a jury trial before a bankruptcy judge, and without their consent the bankruptcy judge has no authority to conduct a jury trial.

The Second Circuit held in *In re Ben Cooper*, 896 F.2d 1394, 1403 (2d Cir. 1990), *vacated and remanded* 498 U.S. 964 (1990), *reinstated on remand* 924 F.2d 36 (2d Cir. 1991), *cert. denied*, 500 U.S. 928 (1991) that "the Seventh Amendment may well render unconstitutional jury trials in non-consensual non-core proceedings, because of the requirement that findings of fact by the bankruptcy court be reviewed *de novo* by the district court * * * but a bankruptcy court has the authority to conduct a jury trial in core proceedings without the parties' consent." *Id.* Therefore, the bankruptcy court has authority to conduct a jury trial in this proceeding without defendants' consent because this proceeding qualifies as a core proceeding under 28 U.S.C. § 157(b).

Recent amendments to the Bankruptcy Code have, however, effectively overruled *Ben Cooper* with respect to the issue of whether the parties must consent to a jury trial in the bankruptcy court in a core proceeding. Title 28 of the United States Code § 157(e) provides that "if the right to a jury trial ap-

plies * * * the bankruptcy judge may conduct the jury trial if specially designated to exercise such jurisdiction by the district court and with the express consent of all the parties." 28 U.S.C. § 157(e) (1999). The effective date of § 157(e), and the remainder of the 1994 Amendments to the Bankruptcy Code (the "1994 Act"), is October 22, 1994. Section 702(b) of the Act provides that "except as provided in paragraph (2), the amendments made by the Act shall not apply with respect to cases commenced under Title 11 of the United States Code before the date of the enactment of this Act"; only five of the 1994 amendments were to be applied retroactively, and § 157 is excluded from that list. See 1994 Act, § 702(b). The legislative history of the 1994 Act indicates that "Section 702 [of the 1994 Act] provides that the amendments made by the Act shall only apply prospectively, except as otherwise and specifically noted therein." H.R. Rep. No. 835, 103rd Cong., 2d Sess. (1994), *reprinted in* 1994 U.S.C.C.A.N. 3340, 1994 WL 567232. Courts in this Circuit have not applied § 157(e) in deciding motions to withdraw filed after the effective date of the Act in cases commenced before the effective date of the Act. See *In re Seatrain Lines. Inc.*, 198 B.R. 45, 53 (S.D.N.Y. 1996) (applying *Ben Cooper*, court held that the bankruptcy court could conduct jury trial without parties' consent in core proceeding); *In re East Hill Manufacturing Corp.*, 200 B.R. 535, 538 (D. Verm. 1996) ("Because this is a core proceeding, the Bankruptcy Court may hold a jury trial.") The instant bankruptcy case was filed on August 11, 1994, approximately two months before the effective date of the revised § 157(e). Therefore, the revised § 157(e) is not applicable to this case and, under the law articulated in *Ben Cooper*, the bankruptcy court has the authority to con-

duct a jury trial in this core proceeding without defendants' consent.

Defendants ask the Court to consider whether the revised Bankruptcy Rule 9015(b) alters this conclusion. That Rule, enacted to implement § 157(e), states that "[i]f the right to a jury trial applies, a timely demand has been filed pursuant to Rule 38(b) Fed. R. Civ. P., and the bankruptcy judge has been specially designated to conduct the jury trial, the parties may consent to have a jury trial conducted by a bankruptcy judge under 28 U.S.C. § 157(e) by jointly or separately filing a statement of consent within any applicable time limits specified by the local rule." Therefore, Rule 9015(b), like § 157(e) but unlike *Ben Cooper*, requires parties to consent to jury trials in the bankruptcy court. In promulgating this Rule, the Supreme Court ordered that it should apply not only to cases filed after its effective date of December 1, 1997, but "insofar as just and practicable, [to] all proceedings in bankruptcy cases then pending." Supreme Court Order Amending Rules of Bankruptcy Procedure (Apr. 11, 1997) 117 S. Ct. front 486. Thus, § 157(e) of the Act and Bankruptcy Rule 9015(b) are in conflict when applied to bankruptcy cases that were filed before October 22, 1994, pending as of December 1, 1997, and in which it would be just and practicable to apply Rule 9015(b).

Title 28 of the United States Code § 2075 empowers the Supreme Court to prescribe by general rules the "practice and procedure under the Bankruptcy Act." It provides further that such rules "shall not abridge, enlarge or modify any substantive right." Bankruptcy rules may not add to, subtract from or vary the provisions of the Bankruptcy Code. See *Meek* v. *Centre County Banking Co.*, 268 U.S.

426, 434 (1924); *Cisneros* v. *United States*, 994 F.2d 1462, 1465 (9th Cir. 1993) (if the bankruptcy rule and the Code itself are in conflict then the statute must take precedence.) Congress has explicitly indicated that § 157(e) should not be applied retroactively to cases, such as the instant case, that were commenced prior to the October 22, 1994, the effective date of the Act. If the Court were to hold that Bankruptcy Rule 9015(b) applies to this case, it would effectively be allowing the Bankruptcy Rule to take precedence over the Act. The Court declines to apply § 157(e) and Rule 9015(b) to this case, and instead applies the Second Circuit's holding in *Ben Cooper* that a bankruptcy judge can conduct a trial in a core proceeding without the parties' consent. Thus, the Court finds that the bankruptcy judge has the authority to conduct a jury trial in this action without the consent of the parties because this is a core proceeding.

III. Conclusion

For the reasons stated above, the Court denies defendants' motion for reconsideration and orders that this action proceed in bankruptcy court. The Clerk of Court is directed to close this case. All pending motions are moot.

SO ORDERED.

DATED: New York, New York
August 13, 1999

s/ Kimba M. Wood
Kimba M. Wood

United States District Judge

Copies of this Order have been mailed to counsel for the parties.

APPENDIX E

[Opinion of the United States District Court For the Southern District of New York (November 13, 1998)]

United States District Court, Southern District of New York

In re CBI HOLDING COMPANY, INC., et al., Debtors,

Bankruptcy Services, Inc., Plaintiff.

v.

Ernst & Young and Ernst & Young, LLP, Defendants,

Case No. 94-B-43819 (BRL)

Adv. Proc. No. 96-9143A

96 CIV 7969 (KMW)

November 13, 1998.

WOOD, U.S.D.J.

Plaintiff, Bankruptcy Services, Inc. ("BSI") filed an action in the United States Bankruptcy Court for the Southern District of New York alleging several claims against defendants that arise out of financial services performed by defendants for plaintiff in 1993 and 1994. Defendants, Ernst & Young and Ernst and Young, LLP, ("E&Y") have submitted a motion requesting that this court: (1) withdraw the reference of this proceeding from the Bankruptcy Court so that the proceeding may continue in this court, and, immediately thereafter, to (2) abstain

from hearing this matter, pursuant to 29 U.S.C. §§ 1334(c)(1) and (2); and (3) dismiss the proceeding *sua sponte*, pursuant to Fed. R. Civ. P. 12(h)(3), for lack of subject matter jurisdiction. The court denies defendants' motion in its entirety and remands the case to the Bankruptcy Court for further proceedings.

I. Background

Prior to bankruptcy, Debtors, the CBI Holding Company, Inc. and its subsidiaries ("CBI"), were one of the a largest full service independent wholesale drug distributors in the United States. (See Steinberg Aff. Exh. A) E&Y was the pre-bankruptcy accounting firm for Debtors. E&Y issued unqualified audit opinions with respect to the Debtors' financial statements for fiscal years 1992 and 1993. (See Amend. Compl. ¶ 60.) In March, 1994, E&Y acknowledged that Debtors' 1993 financial statements were materially inaccurate and withdrew its opinion. Over the next five months E&Y commenced, but did not complete, a reaudit of Debtors' fiscal year 1992 and 1993 financial statements. (*Id.* ¶¶ 96-97)

On August 11, 1994, Debtors filed for bankruptcy.[1] In August 1995, the Bankruptcy Court confirmed the plan of reorganization. (the "Plan") The Bankruptcy Court appointed BSI, plaintiff in this action, as the disbursing agent of the Plan to liquidate Debtors' assets, prosecute claims against third parties, and litigate objections to claims filed against Debtors.

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[1] Debtors allege that the withdrawal of E&Y's opinion was a catastrophe for them, contributing in part to their bankruptcy. (See Am. Compl. ¶¶ 96-99.)

On or about January 10, 1995, E&Y filed a Proof of Claim in Debtors' bankruptcy case in the amount of $210,850 for alleged unpaid services. E&Y's proof of claim states that it "arises from professional services rendered in 1993 and 1994 on behalf of Debtor in connection with the audit of the Debtors' financial statements and other special engagements as described in the attached Exhibits." (See Schein Aff. at Exh. D, E&Y Proof of Claim ¶ 3.) On or about June 13, 1995, the Official Committee of Unsecured Creditors (the "Creditors' Committee") filed an objection (the "Objection") to certain claims filed in Debtors' bankruptcy case, including E&Y's claim. (See Steinberg Aff. ¶ 9). The Objection stated that it was "without prejudice to the Committee's right to object to the within proofs of claim on other grounds as may be necessary." (See Schein Aff. at Exh. E at 9)

On or about October 16, 1996, in its capacity as disbursing agent under the Plan, BSI filed a complaint in Bankruptcy Court against E&Y. On or about October 25, 1996, BSI filed its Amended Complaint, which alleges the assignment to BSI by the Creditors' Committee of the Objection to E&Y's Proof of Claim and the Committee's claims against E&Y.[2] The Amended Complaint concerns E&Y's professional services rendered to Debtors from 1992 to

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[2] The Creditors' Committee executed and delivered to BSI a written assignment dated October 25, 1996, which provided that the Creditors' Committee assigned to BSI "its right title and interest to pursue and prosecute all adversary proceedings and contested matters pending as of the Effective Date of the Plan or thereafter commenced or filed in the Bankruptcy Court or elsewhere including * * * the Litigations and Objections to claims, inclusive of the Objection to the claim of E&Y." (See Steinberg Aff. ¶ 24)

1994.[3] It alleges six claims against E&Y for its mishandling of Debtors' audits and a seventh claim asking that E&Y's Proof of Claim be expunged on the grounds of E&Y's alleged malpractice and misrepresentation as specified in the first six claims.[4] It is this action that E&Y wants withdrawn from the Bankruptcy Court.

II. Discussion

The Second Circuit has noted that district courts in this circuit have considered a number of factors in evaluating a motion to withdraw a reference from the Bankruptcy Court, including: whether the claim or proceeding is core or non-core within the meaning of 28 U.S.C. § 157,[5] whether it is legal or equitable,

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[3] Specifically, the Amended Complaint alleges that Robert Castello, former CEO of CBI, engaged in a fraudulent scheme to understate the Debtors' liabilities in order to inflate his bonus. BSI alleges that, among other things, E&Y negligently failed to find the understated liabilities in performing audit services for fiscal years 1992 and 1993, and that E&Y breached its duty of professional care and competence to CBI by not timely and adequately rendering reaudit services to CBI in 1994.

[4] BSI alleges the following seven claims against E&Y, all of which are associated with the financial services provided from 1992 to 1994: (1) breach of debtor's contract with E&Y for financial services; (2) negligence in conducting the auditing services; (3) negligent misrepresentation to Debtors that the fiscal 1992 and 1993 financial statements were materially accurate; (4) fraud/recklessness misrepresentation that the fiscal statements for 1992 and 1993 were materially accurate; (5) fraud/recklessness regarding the reaudit work E&Y performed for Debtors in 1993 and 1994; (6) breach of fiduciary duty by E&Y in not disclosing to Debtors any matters that might have affected CBI's business decisions; and (7) expungement of E&Y's Proof of Claim on the basis of the foregoing allegations.

[5] Upon referral from the district court, the bankruptcy court "may hear and determine all cases under title 11 and all core

considerations of efficiency, prevention of forum shopping, and uniformity in the administration of bankruptcy law. See *In re Orion Pictures Corp.*, 4 F.3d 1095, 1101 (2d Cir. 1993) (citing *In re Kenai Corp.*, 139 B.R. 59, 61 (S.D.N.Y. 1992)). In its decision, the court recognized that the most important of these factors was whether a proceeding was "core" or "non-core."

A. Determination of a Core Proceeding

The principal issue in this case is whether BSI's action against E&Y, which it brings on behalf of Debtors, should remain in the Bankruptcy Court as a "core proceeding" under 28 U.S.C. § 157(b)(2) or if this Court should withdraw the reference to the Bankruptcy Court pursuant to 28 U.S.C. § 157(d). Plaintiff argues, among other things, that the allegations in its Amended Complaint constitute counterclaims to E&Y's Proof of Claim, filed in Bankruptcy Court, and as such are "core bankruptcy proceedings" pursuant to 28 U.S.C. § 157(b)(2)(C).[6] Defendants argue that BSI's claims cannot be characterized as counterclaims because the Amended Claim is based solely on state law and seeks affirmative relief, and as such falls outside the jurisdiction of the Bankruptcy Court.[7] (See Def. Mem. at 11, 15-18.)

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proceedings arising under title 11, and all core proceedings arising under title 11, or arising in a case under title 11 * * * and may enter appropriate orders and judgments." 28 U.S.C. § 157(b)(1).

[6] Section 157(b)(2)(C) of Title 28 provides that "counterclaims by the estate against persons filing claims against the estate" are considered core proceedings.

[7] E&Y also contends that BSI's claims are not core under § 157(b)(2) because BSI never interposed an objection to E&Y's Proof of Claim and the deadline under the Plan for asserting ob-

The dispositive test of a counterclaim as defined in § 157 is whether it arises from the "same transaction" as the proof of claim. (See *Commodity Futures Trading Comm'n* v. *Schor*, 478 U.S. 833, 852 (1986) (recognizing a bankruptcy court's power to hear and decide state law counterclaims against a creditor who filed a claim in bankruptcy when those claims arose out of the "same transaction.") Bankruptcy courts have also held that a debtor's counterclaims to a creditor's proof of claim qualify as core proceedings where there is a connection between the claims, and a ruling on debtor's complaint would be dispositive of the creditor's claim. See *In re Fang Operators* v. *Carpenter*, 158 B.R. 643 (Bankr. N.D. Tex. 1993)

Furthermore, as plaintiff points out, bankruptcy courts uniformly treat malpractice claims asserted by a debtor following the filing of a proof of claim by a professional for fees, as core proceedings. (See Pl. Mem. at 10) See *e.g.*, *In re Frost, Inc.*, 145 B.R. 678, 880 (Bankr. W.D. Mich. 1992); *In re Direct Satellite Communications, Inc.*, 86 B.R. 390, 391 (Bankr. E.D. Pa. 1988)

E&Y's Proof of Claim arises from the financial services that E&Y provided to CBI in 1993 and 1994, the same services at issue in plaintiff's Amended Complaint. The Amended Complaint alleges violations of state laws by E&Y in regard to the audits that E&Y performed in 1993 and 1994, the same audits that E&Y claims never to have been compensated for in its Proof of Claim. Indeed, the seventh

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jections has passed. (See Def. Mem. at 14-15.) The Court can summarily dismiss this argument on the ground that the Creditors' Committee timely objected to E&Y's Proof of Claim, and assigned to BSI its objection and right to prosecute. (See Amend. Compl. Exh. A, ¶ 1.)

claim asserted by BSI is for expungement of E&Y's Proof of Claim. As such, the Amended Complaint and the Proof of Claim are related, arise out of the same transaction, and a determination of plaintiff's claims would likely be dispositive of E&Y's claims. The Amended Complaint therefore qualifies as a core proceeding pursuant to 28 U.S.C. § 157(b)(2)(C).

Defendants argue that BSI's claims can not qualify as "core" claims under the counterclaims provision because they seek affirmative relief and because they are based on state law. (See Def. Mem. at 9, 14) The fact that BSI seeks affirmative relief does not affect the determination of the claims as core claims. In many cases, courts have held that a debtor's action was a "core" proceeding where the debtor commenced an independent action seeking relief against a defendant who previously filed a proof of claim, even if the debtor sought relief far in excess of the creditor's claims. See, *e.g.*, *In re Sun West Distributors*, 69 B.R. 861, 863 (Bankr. S.D. Cal. 1987) (proof of claim for $1.1 million and counterclaim for $3.7 million); *Matter of Baudoin*, 981 F.2d 736, 738 (5th Cir. 1993) (allowed claim for $360.000 and counterclaim for $4 million). Nor does the fact that BSI's Amended Complaint alleges state law claims preclude it from being a core proceeding.[8] Section

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[8] The cases defendants cite for the proposition that state law claims cannot be core claims are not controlling here either because they do not involve defendants who have filed a formal proof of claim in the bankruptcy court or because they involve pending state court proceedings instituted prior to the debtor's filing of a petition for bankruptcy. (See Def. Mem, at 10, 12) Here, E&Y did file a formal Proof of Claim and there is no pending pre-petition proceeding on BSI's state law claims in the state courts.

157(b)(3) of Title 28 expressly provides that "a determination that a proceeding is not a core proceeding shall not be made solely on the basis that its resolution may be affected by State Law." 28 U.S.C. § 157(b)(3). The decisions interpreting this provision indicate that the relevant inquiry in deciding if a proceeding is core is whether the nature of the claims fall within the core of federal bankruptcy power, not whether they are based on state law claims. See *In re Manville Forest Products Corp.*, 896 F.2d 1384, 1389 (2d. Cir 1990) (holding that the mere fact that a claim "raises issues of state law does not preclude a holding that the adversary proceeding is core"); see also *In re Ben Cooper, Inc.*, 896 F.2d 1394, 1398 (2d. Cir. 1990) (Section 157(b)(3) demonstrates "Congress' intent that bankruptcy courts are not precluded from adjudicating state law claims * * *.")

Finding that plaintiff's adversary proceeding against E&Y constitutes a "core proceeding" pursuant to § 157(b)(2)(C), the Court need address only briefly plaintiff's other arguments for why this proceeding constitutes a "core proceeding." Plaintiff contends that the Amended Complaint is also a core proceeding pursuant to § 157(b)(2)(B) because it inevitably impacts on the allowance or disallowance of E&Y's Proof of Claim.[9] Plaintiff is correct in this assertion because E&Y's Proof of Claim will be disallowed if BSI's lawsuit is successful. See *In re Manville*, 896 F.2d 1384, 1388 (2d Cir. 1990) (the adversary proceeding at issue here involves a simple objection to a proof of claim and clearly falls within the

[9] Section 157(b)(2)(B) of Title 28 provides that core proceedings include: "allowance or disallowance of claims against the estate * * *."

literal language of § 157(b)(3)(B)). The Bankruptcy Court must resolve the merits of the adversary proceeding that BSI brings against E&Y before it can determine the allowed amount of E&Y's claim, as such it is an inextricable part of the allowance/disallowance process. See *Frost*, 145 B.R. at 882 (debtor's malpractice claim was an inextricable part of the claims allowance process).

Finally, plaintiff asserts that BSI's claims are core matters under the "catch-all" provisions of § 157(b)(2)(A) and (O).[10] BSI's claims against E&Y are a part of the administration of Debtors' estate insofar as the resolution of those claims will determine the amount that the estate will have to dispense to E&Y; these claims therefore fall within the category of "core proceedings" pursuant to 28 U.S.C. § 157(b)(2)(A). The resolution of BSI's claims will also adjust the debtor-creditor relationship between Debtor and E&Y and will affect the liquidation of the assets of the estate; as such BSI's claims are core matters pursuant to 28 U.S.C. § 157(b)(2)(O).[11] See *Langenkamp* v. *Culp*, 498 U.S. 42, 44 (1990) (creditor's claim and the ensuing action by the trustee

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[10] The "catch-all" provisions provide that core proceedings include: (1) "matters concerning the administration of the estate," 28 U.S.C. § 157(b)(2)(A), and (2) "other proceedings affecting the liquidation of the assets of the estate or the adjustment of the debtor-creditor or the equity security holder relationship, except personal injury tort or wrongful death claims," 28 U.S.C. § 157(b)(2)(O).

[11] Defendants' argument that the court's decision in *Orion* eliminated these catch-all provisions from the core/non-core analysis is unavailing. See *Orion*, 4 F.3d at 1102 ("it is clear that Congress intended 157(b)(2)(A)'s [and (O)'s] designation of matters relating to the administration of the estate as core to encompass a wide range of matters * * *.")

against the creditor were integral to the restructuring of the debtor-creditor relationship)

Accordingly, for the reasons stated above, this Court finds that BSI's action against E&Y constitutes a "core-proceeding" within the meaning of 28 U.S.C. § 157(b)(2).

B. Judicial Economy

The Court in *Orion* also suggested that a district court consider judicial economy in deciding whether to withdraw a proceeding from the Bankruptcy Court. As stated in detail in the record, Bankruptcy Judge Lifland has indicated that the dispute between Debtors and E&Y is a mature one and one with which he is very familiar; he has conducted hearings and supervised discovery disputes in this proceeding.[12] (See Steinberg Aff. ¶ 18) Furthermore, Judge Lifland is also presiding over a litigation commenced in Bankruptcy Court by BSI against the former CEO of CBI that concerns the allegedly fraudulent practices that E&Y failed to uncover in the 1992 and 1993 audits, and extensive discovery has taken place in this case since November, 1994. (See Steinberg Aff. ¶ 12). Although they are different proceedings, the instant proceeding and BSI's action against the former CEO arise from the same set of factual circumstances. Given the vast knowledge already accumulated in the Bankruptcy Court in this case and the fact that Bankruptcy judges routinely adjudicate state law claims of negligence/fraud by debtors

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[12] In November 1994, Debtors obtained a Bankruptcy Court order directing E&Y to produce documents relating to Debtors' materially misstated financial statements for fiscal years ending 1992 and 1993. E&Y produced nearly 30,000 pages of documents. (See Steinberg Aff. ¶ 113)

against professional services companies, the interests in judicial economy are best served if this case remains in the Bankruptcy Court.

III. Conclusion

For the reasons stated above, the court denies defendants' motion in its entirety and this case is hereby remanded to the Bankruptcy Court for further proceedings.

SO ORDERED.

DATED: New York, New York
November 13, 1998

s/ Kimba M. Wood

Kimba M. Wood

United States District Judge

Copies of this Order have been mailed to counsel for the parties.

APPENDIX F

[Memorandum Decision and Order of the United States Bankruptcy Court For the Southern District of New York (September 3, 1999)]

United States Bankruptcy Court, Southern District of New York

In re CBI HOLDING COMPANY, INC., et al., Debtors.

Bankruptcy Services, Inc., Plaintiff.

v.

Ernst & Young and Ernst & Young, LLP, Defendants.

Case No. 94 B 43819 (BRL).

Adv. Proc. No. 96-9143A

September 3, 1999.

MEMORANDUM DECISION AND ORDER

Before the court are two motions (the "Motions"). The first is a motion by the defendants (the "Trial Motion"), Ernst & Young and Ernst & Young, LLP (collectively, "E&Y") for an order, pursuant to Federal Rule of Civil Procedure 60(b), made applicable herein by Federal Rule of Bankruptcy 9024, vacating certain provisions (the "Trial Provisions"), of an order dated May 20, 1999 (the "Trial Order"). The Trial Order provides for the bifurcation of the trial of this adversary proceeding, the date for the filing of a pretrial order and the trial date. E&Y sought vaca-

tur of the Trial Order on the grounds that this court lacked the authority to conduct the jury trial allegedly required in this case and that the bifurcation provision of the Trial Order violated E&Y's right to a jury trial.

The second is a motion by Bankruptcy Services, Inc. ("BSI"), as liquidating agent of CBI Holding Company, Inc. ("CBI") and its subsidiaries, (collectively, CBI and its subsidiaries, the "Debtors"), for an order striking E&Y's jury trial demand. During the period when these motions and the responses thereto were filed with this court, certain of the issues were *sub judice* before the district court, primarily in the form of a motion to reargue the district court's denial of a motion to withdraw the reference of the adversary proceeding from this court. Since the filing of the motions in this court, the district court issued its opinion (the "1999 Decision"), deciding many of the issues raised before both courts. Accordingly, the underlying issue fundamental to both Motions and the only issue remaining for this court to decide is whether E&Y has a right to a jury trial.

Background

On August 11, 1994, the Debtors filed voluntary petitions for relief under chapter 11 of the Bankruptcy Code. The Debtors' plan of reorganization (the "Plan"), was confirmed in August 1995. In January 1995, E&Y filed a proof of claim against the Debtors in the amount of $210,850 for alleged unpaid services. In June 1995, the official committee of unsecured creditors (the "Creditors Committee"), filed an objection to E&Y's claim.

In October 1996, BSI, in its capacity as disbursing agent under the Plan, commenced this adversary

proceeding against E&Y based on the assignment to BSI by the Creditors' Committee of the objection to E&Y's proof of claim. The complaint, as amended (the "Amended Complaint"), concerns E&Y's professional services rendered to the Debtors from 1992 to 1994. It alleges six claims against E&Y for its mishandling of the Debtors' audits and a seventh claim seeking expungement of E&Y's proof of claim. The Amended Complaint contained a request for a jury trial.

On October 18, 1996, E&Y filed a motion for an order withdrawing the reference of the adversary proceeding from this court. By opinion and order dated November 13, 1998 (the "1998 Decision"), the district court denied E&Y's motion in its entirety and remanded the case to this court for further proceedings, based on its finding that the Amended Complaint qualified as a core proceeding pursuant to 28 U.S.C. § 157(b)(2)(C). In December 1998, E&Y moved to reargue (the "Reconsideration Motion"), the 1998 Decision. On March 4, 1999, while the Reconsideration Motion was pending, E&Y filed a motion in this court to dismiss certain of the claims in the Amended Complaint. With the exception of one claim, the motion to dismiss was denied by this court on April 21, 1999. On May 4, 1999, BSI filed a Notice of Withdrawal of Jury Trial Demand. The following day, E&Y filed its answer (the "Answer"), to the Amended Complaint and demanded a jury trial.

While the Reconsideration Motion was *sub judice* and after entry of this court's Trial Order, E&Y moved, by order to show cause, in the district court for an order withdrawing the reference of this adversary proceeding for the purposes of trial and staying certain related proceedings in this court (the "Jury

Trial Withdrawal Motion"). By order dated July 1, 1999, the district court vacated the order to show cause and determined to consider the Jury Trial Withdrawal Motion as part of the Reconsideration Motion. The district court did not stay proceedings in this court.

On August 13, the district court issued the 1999 Decision (i) reaffirming the 1998 Decision and (ii) denying E&Y's motion for reconsideration. In the 1999 Decision, the district court reiterated that all the claims asserted by BSI in the Amended Complaint were "core" and, assuming that the right to a jury trial exists, that under the Second Circuit's decision in *Ben Cooper, Inc.* v. *The Ins. Co. of the State of Penn.* (*In re Ben Cooper, Inc.*), 896 F.2d 1394 (2d Cir.), *cert. granted*, 497 U.S. 1023, *vacated and remanded*, 498 U.S. 964 (1990), *reinstated*, 924 F.2d 36, *cert. denied*, 500 U.S. 928 (1991), this court is empowered to conduct a jury trial of this adversary proceeding without the consent of the parties. See 1999 Decision at 10-11. Many of the issues raised by the parties in the Motions now before me have been decided by the district court. The district court did not have before it, however, the question of whether E&Y has a right to a jury trial.

Discussion

The Seventh Amendment provides, "[i]n Suits at common law, where the value in controversy shall exceed twenty dollars, the right of trial by jury shall be preserved." U.S. Const. amend. VII. The Supreme Court interprets "suits at common law" to mean cases involving legal rights; no jury right attaches to equitable claims. *Granfinanciera, S.A.* v. *Nordberg*, 492 U.S. 33, 41-42 (1989). In determining whether a claim is equitable or legal, the Supreme Court pro-

vided the following analysis. First, a court must compare the statutory action to 18th-century actions brought in the courts of England prior to the merger of the courts of law and equity. Second, the court must examine the remedy sought and determine whether it is legal or equitable in nature. *Id.* at 42. However, not all legal claims command the right to a jury trial. *Id.* at 42 n.4. If, on balance, these two factors indicate that a party is entitled to a jury trial under the Seventh Amendment, the court must decide whether Congress may assign and has assigned resolution of the relevant claim to a non-Article III adjudicative body that does not use a jury as fact-finder. *Id.* at 42. The distinction between what types of traditionally legal remedies and causes of action might be constitutionally deprived of a right to trial by jury turns on whether public or private rights are involved. The adjudication of public as distinguished from private rights may be congressionally assigned to a tribunal for which no right to a jury trial exists without violating the Seventh Amendment. *Id.* at 50-51. *Granfinanciera* provided that Congress cannot eliminate the right to a jury trial by renaming the traditionally legal action and assigning it to a specialized court of equity. *Id.* at 60-61. In reaching its holding, the Supreme Court recognized that a consistent but different result occurs when a creditor has filed a proof of claim against the bankruptcy estate. In so doing, the Court examined its holding in an earlier case, *Katchen* v. *Landy*, 382 U.S. 323 (1966), which considered the creditor's right to a jury trial under the Bankruptcy Act of 1898. In *Katchen* v. *Landy*, the Court held with respect to preference actions that by filing a proof of claim a creditor submits the determination of its rights against the debtor and the bankruptcy estate to the

summary jurisdiction of the bankruptcy court in equity. *Katchen* v. *Landy*, 382 U.S. at 325. Commenting on the creditor's Seventh Amendment right, the Court stated,

> although petitioner might be entitled to a jury trial on the issue of preference if he presented no claim in the bankruptcy proceeding and awaited a federal plenary action by the trustee, when the same issue arises as part of the process of allowance and disallowance of claims, it is triable in equity.

Id. at 336 (citations omitted). The *Granfinanciera* court made clear that the Court's decision in *Katchen* v. *Landy* did not depend on the scope of summary jurisdiction granted to the bankruptcy courts by the 1898 Act. Instead, *Katchen* v. *Landy* turned on the bankruptcy court's having actual or constructive possession of the bankruptcy estate and its power and obligation to consider objections by the trustee in deciding whether to allow claims against the estate. *Granfinanciera S.A.* v. *Nordberg*, 492 U.S. at 57. The Court stated further that

> by submitting a claim against the bankruptcy estate, creditors subject themselves to the court's equitable power to disallow those claims, even though the debtor's opposing counterclaims are legal in nature and the Seventh Amendment would have entitled creditors to a jury trial had they not tendered claims against the estate.

Id. at 59 n.14. Following *Granfinanciera*, the Supreme Court decided *Langenkamp* v. *Culp*, 498 U.S. 42, 44 (1990) (per curiam). *Langenkamp* "seems to formulate a bright-line rule, holding that creditors

who file proofs of claim against the estate are not entitled to a jury trial on matters affecting the allowance of those claims." See *Billing* v. *Ravin, Greenberg & Zackin, P.A.*, 22 F.3d 1242, 1249 (3d Cir.) *cert. denied*, 513 U.S. 999 (1994) (citing *Langenkamp* v. *Culp*, 498 U.S. at 45). See also, *First Fidelity Bank, N.A.* v. *Hooker Investments. Inc.* (*In re Hooker Investments, Inc.*) 937 F.2d 833, 838 (2d Cir. 1991); *Falbaum* v. *Leslie Fay Companies, Inc.* (*In re Leslie Fay Companies, Inc.*), 222 B.R. 718, 720 (S.D.N.Y. 1998) *aff'd*, 182 F.3d 899 (1999) (a creditor who voluntarily participates in the equitable reordering of a debtor's estate by filing a proof of claim has no jury trial rights with respect to proceedings that involve the allowance or disallowance of those claims) (citing *Granfinanciera, S.A.* v. *Nordberg*, 492 U.S. at 58; *Langenkamp* v. *Culp*, 498 U.S. at 44).

As the Second Circuit Court of Appeals explained in *Germain* v. *Connecticut National Bank*, 988 F.2d 1323 (2d Cir. 1993),

> [T]he *Katchen*, *Granfinanciera*, and *Langenkamp* line of Supreme Court cases stands for the proposition that by filing a proof of claim *a creditor forsakes its right to adjudicate before a jury any issue that bears directly on the allowance of that claim*—and does so not so much on a theory of waiver as on the theory that the legal issue has been converted to an issue of equity. It is reasonable that *a creditor or debtor who submits to the equity jurisdiction of the bankruptcy court thereby waives any right to a jury trial for the resolution of disputes vital to the bankruptcy process, such as those involving the determination of who is a valid creditor*

> *and which creditors are senior in the creditor hierarchy.*

Id. at 1329-30 (emphasis added). In explaining the conversion of a legal claim into an equitable one, the Second Circuit explained further that

> For a waiver to occur, the dispute must be part of the claims-allowance process or affect the hierarchical reordering of creditors' claims. Even there the right to a jury trial is lost not so much because it is waived, but because the legal dispute has been transformed into an equitable issue.

Id. at 1330.

In *Germain*, the debtor's prepetition lender filed a proof of claim and the trustee brought suit against it six months later for interference with the debtor's business in the postpetition period. *Id.* at 1325-26. The Second Circuit determined that although the lender had filed a proof of claim for a prepetition debt, the trustee's cause of action for tortious interference arose postpetition and was, therefore, unrelated to the allowance of the creditor's claim. *Id.* at 1328-30. The court was very clear, however, that

> [a] different result might adhere if the action had become part of the claims-allowance process, because determining pro rata distribution is characteristically equitable. See *Katchen*, 382 U.S. at 336 An action that bears directly on the allowance of a claim is integrally related to the equitable reordering of the debtor-creditor and creditor-creditor relations. If an equitable reordering cannot be accomplished without the resolution of what would otherwise be a legal dispute,

> then that dispute becomes an essential element of the broader equitable controversy.

Id. at 1329.

E&Y argues that despite its filing of a proof of claim in the Debtors' cases, it is entitled to a jury trial because the claims in the Amended Complaint are legal in nature, do not relate to the proof of claim filed by E&Y and are not part of the claims-allowance process. E&Y is incorrect. In both the 1998 and 1999 Decisions, the district court clearly found that the claims in the Amended Complaint relate to the proof of claim and are an inextricable part of the claims-allowance process.

In its 1998 Decision, the district court found initially that:

> E&Y's proof of claim arises from the same financial services that E&Y provided to CBI in 1993 and 1994, the same services at issue in the Amended Complaint. The Amended Complaint alleges violations of state laws by E&Y in regard to the audits that E&Y performed in 1993 and 1994, the same audits that E&Y claims never to have been compensated for in its Proof of Claim. Indeed, the Amended Complaint and the Proof of Claim are related, arise out of the same transaction, and *a determination of plaintiffs claims would likely be dispositive of E&Y's claims.*

See 1998 Decision at 7 (emphasis added). The district court also found that the Amended Complaint "inevitably impacts on the allowance of E&Y's proof of claim * * * because E&Y's proof of claim will be disallowed if BSI's lawsuit is successful." *Id.* at 9. Thus, the district court explained, because

> the Bankruptcy Court must resolve the merits of the adversary proceeding that BSI brings against E&Y before it can determine the allowed amount of E&Y's claim, * * * *it is an inextricable part of the allowance/disallowance process.*

See 1998 Decision at 9-10 (emphasis added) *citing Frost Inc.* v. *Miller, Canfield, Paddock & Stone, P.C.* (*In re Frost. Inc.*), 145 B.R. 878, 882 (Bankr. W.D. Mich. 1992) (debtor's malpractice claim was an inextricable part of the claims-allowance process.)

In *Frost*, the bankruptcy court held that the debtor's claim of malpractice against its former attorney constituted an objection arising against the debt owed to the attorney for uncollected fees and thus, denied the debtor's request for a jury trial. *In re Frost, Inc.*, 145 B.R. at 882-83.

In *Germain*, the Second Circuit discussed the *Frost* decision noting that

> "To the extent that the court is suggesting that the debtor was essentially objecting to the allowance of the attorney's claim and that the debtor's success meant the disallowance of the attorney's claim, we agree that the debtor's objection was part of the claims-allowance process."

Germain v. *Connecticut National Bank*, 988 F.2d at 1330 n.9. See also *Billing* v. *Ravin, Greenberg & Zackin, P.A.*, 22 F.3d at 1252 ("The close connection between the malpractice action [against the debtor's attorneys] and the objections to [the attorneys'] fees leads us to conclude that the debtors' allegations of malpractice are part of the process of allowance and disallowance of claims.")

In the 1998 Decision, the district court also found that the "resolution of BSI's claims will also *adjust the debtor-creditor relationship* between Debtor and E&Y and will affect the liquidation of the assets of the estate * * *." See, 1998 Decision at 10. (emphasis added) (citing *Langenkamp*, 498 U.S. at 44) (creditor's claim and the ensuing action by the trustee against the creditor were integral to the restructuring of the debtor-creditor relationship.). Moreover, "BSI's claims constitute counterclaims to defendants' Proof of Claim * * *." See 1999 Decision at 5. Based on all of the foregoing, it is clear that E&Y's claim and the Amended Complaint are sufficiently interrelated such that, under *Germain*, even the legal claims in the Amended Complaint can be decided by this court without a jury as part of the broader equitable controversy.

Conclusion

In sum, E&Y voluntarily participated in the equitable reordering of the Debtors' estates by filing a proof of claim in these bankruptcy cases. BSI's claims in the Amended Complaint are an "inextricable part" of the allowance or disallowance of E&Y's claim against these estates and the adjustment of the debtor-creditor relationship. Accordingly, BSI's motion to strike E&Y's jury trial demand is granted; E&Y's Trial Motion is denied. A bench trial shall go forward as scheduled.

IT IS SO ORDERED.

Dated: New York, New York, September 3, 1999
s/ Burton R. Lifland

Burton R. Lifland

United States Bankruptcy Judge

APPENDIX G

[Order of the United States Court of Appeals For the Second Circuit Denying E&Y's Petition for Rehearing (October 15, 2008)]

United States Court of Appeals, Second Circuit.

In re CBI HOLDING COMPANY, INC., Debtor,

Bankruptcy Services, Inc., Plaintiff–Appellant–Cross–Appellee,

v.

Ernst & Young, Ernst & Young LLP, Defendants–Appellees–Cross– Appellants.

Docket Nos. 04–5972–bk(LEAD), 04–6300–bk(XAP).

October 15, 2008.

At a stated term of the United States Court of Appeals for the Second Circuit, held at the Daniel Patrick Moynihan United States Courthouse, 500 Pearl Street, in the City of New York, on the 15th day of October two thousand and eight,

Ernst & Young, Ernst & Young LLP having filed a petition for panel rehearing, or, in the alternative, for rehearing *en banc*, and the panel that determined the appeal having considered the request for panel rehearing, and the active members of the Court having considered the request for rehearing *en banc*,

IT IS HEREBY ORDERED that the petition is DENIED.

For the Court:

Catherine O'Hagan Wolfe, Clerk

By: s/ Frank Perez

Frank Perez, Deputy Clerk